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PERSPECTIVES ON REGULATION OF SYSTEMIC RISK IN THE FINANCIAL SERVICES INDUSTRY

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

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PERSPECTIVES ON REGULATION OF SYSTEMIC RISK IN THE FINANCIAL SERVICES INDUSTRY

Tuesday, March 17, 2009

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

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

Members present: Representatives Frank, Kanjorski, Waters, Maloney, Velazquez, Watt, Sherman, Meeks, Moore of Kansas, Capuano, Hinojosa, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Ellison, Klein, Perlmutter, Donnelly, Foster, Carson, Speier, Driehaus, Grayson, Himes; Bachus, Castle, Royce, Manzullo, Biggert, Hensarling, Garrett, Barrett, Neugebauer, Price, McHenry, Campbell, Marchant, McCarthy of California, Posey, Jenkins, Lee, Paulsen, and Lance.

The CHAIRMAN. The hearing will come to order. The purpose of this hearing is to continue to focus even more on a very broad question, the importance of an effect that has been undermined by recent events and by the considerably larger crowd we will have here tomorrow when we deal with the apparently three most fearsome letters in the English language: "AIG." We will deal with that tomorrow. But what we need to do is to figure out how we avoid ever again being in this situation. "Ever again" overstates it. How do we make it much less likely that we are not again in this situation?

So this begins a set of hearings that we are going to be having on what, if anything, should be done at the legislative level and then carrying through obviously to the executive level to prevent some of the problems that we are now dealing with from recurring. There will be a series of hearings. As you know, the Secretary of the Treasury will be testifying at our hearing on March 26th. But we want to hear from a wide range of people on the consumer side, on the labor side, and on the financial industry side, former regulators, other commentators, and people in the industry. We will have a series of hearings on this. We have several hearings planned between now and the break. We will resume and continue the hearings, and it is my hope that we will be able to begin the drafting of legislation sometime in early May. That is when we come back and have a couple more weeks of hearings.

I urge people to be thinking seriously about what we are doing. This will be a lengthy process. It will go through all of the regular

order. The Senate also is engaged in this. The White House and the Treasury are engaged in it. It is a very important task, and we will be addressing it with great seriousness and with full input. I am not at this point going to get into anything substantive because I really hope that we will have a full and unfettered conversation with a variety of people about this, and I would hope people would feel totally free to make whatever recommendations they may have. Everyone who is here will, I am sure, be asked again to comment on this, but you don't have to wait to be asked. We have as important a task as we have had in this general area, I believe, since the 1930's.

But I will just say briefly what seems to me to be the situation. We are a society that understands the value of free enterprise in a capitalist system in creating wealth. Some political rhetoric to the contrary, that is not in question now, and won't be in question in the future. No one is seriously talking about diminishing the role of the private sector as the wealth creator, and for this committee's jurisdiction of the financial services industry as the intermediary, as the entity that helps accumulate wealth from a wide variety of sources and makes it available for those who will be taking the lead in the productive activity, that is the intermediation function, and it is a very important one.

From time to time in economic life, the private sector, which is constantly innovating, but achieves the level of innovation that is almost a qualitative change when a very new set of activities comes forward. Now, by definition, if those activities do not provide value to the society, they die of their own weight. Only those that are in fact genuinely adding significant value thrive. But also by definition because they are innovative, as they thrive they do a lot of good, but there is some damage because they are operating without rules, they are new, and that is why I think the problem here is not deregulation, but nonregulation. It is not that rules that had been in place were dismantled, it is that as new activities come forward there need to be new rules that are put in place that to the maximum extent possible provide a structure in which the value of these innovations can continue but some of the abuses are restricted.

I will give two examples where it seems to me we went through that process. In the late 19th Century, the formation of the large industrial enterprises, then called trusts. This country could not have industrialized. The wealth could not have spread to the extent that it has here or elsewhere without large enterprises. But because they were new, there were not rules. So while they were formed and thrived in the late 19th Century and on into the next century, the presidencies of Theodore Roosevelt and Woodrow Wilson were aimed at preserving the value while containing the damage that could be done. The antitrust acts, the Federal Trade Act, even the Federal Reserve Act itself came out of that situation.

Because you had the large enterprises you then had the stock market become so important, because you had now gone beyond what individuals could finance. And the stock market obviously provided an important means of support for this process, but with some abuses. So in the New Deal period and then after we had

rules adopted that gave us the benefits of this finance capitalism but tried to restrain some of the abuses, the SEC and other factors.

I believe that securitization, the ability to use pools of money not contributed by depositors, and are therefore relatively unrestricted, to finance activities and to sell the right to be repaid, obviously has a lot of advantages. If mortgage loans can be made, securitized, and remade, that money can support a lot more activities. Securitization greatly increases the ability to use the money. But like these other innovations it comes in an area without regulation. And our job now I believe is in some ways comparable to what happened under Franklin D. Roosevelt or Theodore Roosevelt and Woodrow Wilson, to come up with a set of rules that create a context in which a powerful, valuable tool can go forward in its contributions but with some restriction on the negative side. And that is never easy to do and you never do it 100 percent.

I regard it, by the way, as very much a pro-market enterprise, because one of the problems we have now is an unwillingness on the part of many who have the money to make it available. We have investors who are reluctant to get involved. That is a great problem. It is nice from the standpoint of calculating our interest costs to have Treasuries be so popular. But it is not healthy for the economy for Treasuries to be disproportionately the investment people want to make.

One of the advantages of this being done properly is to get a set of rules that will tell investors that it is safe to get back into the business of investing. So we regard this again as very pro-market, of taking a market-driven innovation, in this case securitization, and trying to preserve its value while limiting some of the harm that comes when it acts in a totally unregulated atmosphere and in a manner that will give a great deal of confidence to investors so that we can resume this function of intermediation of gathering up resources and making them available for productive uses.

The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman. I yield 1½ minutes.

The CHAIRMAN. I am sorry. Whatever time you want; 1½ minutes.

Mr. BACHUS. Thank you.

Mr. Chairman, done in the right way, a systemic risk entity can be a positive step. However, if done in the wrong way, it can be a very bad idea. Let me be very clear. It is time that we extricate ourselves from the cycle of multi-billion dollar taxpayer-funded bailouts. Before we agree on the creation of a systemic risk regulator or observer, we need to agree on one important precondition, and that is that this so-called systemic risk regulator should not have the power to commit or obligate billions or hundreds of billions of dollars of taxpayer money to bailing out the so-called "too big to fail" institutions. If it does, I can't support it.

In the event of a failure of one of these too big to fail institutions, I believe that this newly created entity's role should be to advance an orderly resolution, not to add taxpayer funding. If we have learned one lesson in the last year it is this: When the government tries to manage and run these large corporations, no one wins. Government ownership and management of the private sector didn't work in Russia, it didn't work in China, it is not working in

Cuba, it is not working in North Korea, and it is clearly not working here.

Thank you, Mr. Chairman.

The CHAIRMAN. Does the gentleman have a second member, because I did 5 minutes? You have a minute-and-a-half. The gentleman from California, Mr. Royce, for a minute-and-a-half.

Mr. ROYCE. Thank you, Mr. Chairman. I would like to thank our witnesses for coming and also, considering the topic of today's hearing, systemic risk, I would like to briefly welcome Mr. Wallison from AEI who for years warned and wrote about the systemic risk posed by Fannie Mae and Freddie Mac to our system. And with trillions of dollars being allocated to prop up our financial system we must begin to rethink, I think, the relationship between the Federal Government and private companies. If we allow this line to be permanently blurred, the invitation for political and bureaucratic manipulation will remain, as we saw with the GSEs. Further, the market distortions caused by the implied government guarantee of Government-Sponsored Enterprises allowed them to operate as a duopoly, walled off from forces such as market discipline that would have significantly lessened the ability of these firms to play their part in inflating the U.S. housing market and allowed them eventually to overleverage by over 100 to 1.

With that said, I believe that we have to reevaluate our financial market's regulatory structure. That is what this hearing is about. We need a thoughtful reevaluation. We have a patchwork system put together over the last 75 years in this country, and we cannot discuss systemic risk regulation in a vacuum. Duplicitous and ineffective regulatory bodies must be consolidated or eliminated, and gaps exploited in recent months by AIG must be filled.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from California for 2 minutes.

Mr. SHERMAN. Thank you. I think the ranking member points out something interesting, and that is if the Fed is the systemic risk regulator, or any kind of regulator, they could see their regulation called into question, "Oops, you made a mistake." And they could cover themselves by using their powers under section 13(3) to make unlimited loans from the Fed. I think we need to divorce the rescue authority from the regulatory authority or a regulator may do a rescue in order to cover up the fact that their regulatory authority was not used all that prudently.

Secondly, if the Fed is going to be a systemic risk regulator we ought to make sure that all of its officers and decisionmakers are appointees of the President or appointees of appointees of the President, that none are appointed by committees of private bankers. The Fed needs to be clearly just a government agency and not also an association of banks.

As to systemic risk, it can be prevented perhaps by higher capital requirements, but when we do confront systemic risk that has to be acted, this systemic risk regulator needs to be respond with receiverships, not with bailouts. Never again should the taxpayer be called upon to bear risks or to bear costs. And no activity which is too big to be covered by a receivership should be allowed because nobody should be allowed to bet if the taxpayer is going to be called upon under the theory of systemic risk or any other theory to bail

them out. No casino should be too so big that we can't let those who break the bank deal with it in the private sector.

Finally, and this is off point, I look forward to working with other colleagues on a tax law that would impose a substantial surtax on excessive compensation paid to executives at bailed-out firms, especially AIG. It is clear that we have until April 15, 2010, to act on the 2009 Tax Code, and I think we could act on 2008 as well.

The CHAIRMAN. The gentleman from Illinois for 1½ minutes.

I apologize. The gentleman from Texas for 1½ minutes.

Mr. HENSARLING. Thank you, Mr. Chairman. No doubt we would all love to figure out a way to properly end systemic risk, but it kind of begs the question who, what, how, and at what cost? I have a number of questions. Number one, do we have any other examples where this has been tried before and tried successfully? Has it worked? And if not, why not? Who are the so-called experts on the subject? Second of all, what is our accepted definition of systemic risk? Is it too big to fail, too interconnected to fail? I note that mutual funds have worldwide assets of $26.2 trillion at the end of the last fourth quarter. Are they too big to fail? Are they representative of systemic risk? Next, which of our regulators is to be trusted with this responsibility? Should it be the Federal Reserve that many economists view helped lead us into this housing bubble in the first place? Perhaps it should be the SEC, who apparently knew about the Madoff fraud and did nothing about it. Perhaps OTS, who is responsible for IndyMac, the largest bank failure in American history. If not them, who?

The next question is to what extent does this become a self-fulfilling prophecy? Once you designate a firm too big to fail, then is this not Fannie and Freddie revisited with only the taxpayers left to pick up the tab?

There are many questions to be asked. I look forward to hearing from our witnesses, and I yield back the balance of my time.

The CHAIRMAN. The gentleman from New Jersey, Mr. Garrett, for 1½ minutes.

Mr. GARRETT. Thank you, Mr. Chairman. And while we look at systemic risk, and there are some who are calling for consolidating even more regulator power and risk within the Fed to look at systemic risk, I find myself on the other side increasingly adverse to the idea. Now, the Fed has already been the de facto systemic regulator for at least much of our banking sector, which by the way is already the most regulated portion of our economy. Institutions like Citigroup and other large banks have some of the thorniest problems that we are facing in our financial markets. So instead of giving Fannie even more problems, despite its regulatory failures, I am convinced that we should actually reduce the regulatory powers and maybe at best let it concentrate on its monetary policy. The Fed's regulatory role, if it were to be increased, compromises its independence and threatens to undermine the value of the dollar.

The reason for the Fed's independence in the first place is its monetary policies duties, not its regulatory role. It is difficult to see a scenario where the Fed is responsible for the health of our Nation's largest financial institutions would be reluctant to raise in-

terest rates in order to assist financial institutions under its regulatory purview.

Furthermore, in addition to my concerns about the conflictive nature of the Fed's role, as I mentioned at last week's hearing, I also have concerns about consolidating so much additional power in any entity that does not have to answer to the American people.

Finally, beyond my specific concerns about the Fed, I have broader concerns, as Mr. Hensarling raises, about a new systemic regulator. What powers would it have? Would it be able to say what it is and what it is not allowed to invest in? And in its zeal to eradicate risk, and remember, this is a capitalist economy, would it fundamentally alter the nature of the American economy, the greatest economic engine in the history of the world by doing so?

I thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Massachusetts is recognized for 2 minutes, Mr. Capuano.

Mr. CAPUANO. Thank you, Mr. Chairman. Mr. Chairman, I was going to comment on your comment about AIG being the word of the week, and you are right about that, but that is short term. The biggest word we dealt with for 30 years, and I think the reason you are here, is the word "regulation." It has been a swear word in Washington for 30 years. We don't regulate anything. We haven't overseen anything or anybody, and the few regulators we have have chosen not to do anything with the powers they have.

Yet I have to be honest; I think you just heard the major problem that we in Congress will have. I don't think anybody in America today thinks there is too much regulation in the financial services industry except some of my friends on the other side of the aisle. And I have to be honest, I thought that debate was over. I think it is over for most of us and for most of America. What I want to hear today and what I want to hear from the next point forward is not whether regulation is a swear word, but how do we do it? Who should be included? Who should be excluded, if anyone?

I can't imagine any arguments why anybody would say that bank SIVs, Special Investment Vehicles, should be excluded from regulation where the bank isn't. I can't imagine anybody today telling me that hedge funds should have absolutely no regulation. I can't imagine anybody today telling me that private equity firms should have absolutely no regulation. I can't imagine anybody today certainly not telling me that credit rating agencies shouldn't be regulated by anybody.

Those things are past. The lack of regulation is unequivocally, clearly, undebatably the reason that we have the economic crisis we have today. The fair and only question left is, how do we regulate in a reasonable and thoughtful manner? No one wants to overregulate, but no one in their right mind wants to under regulate anymore. It is a fair question and a moving question as to how to do it in format, how to structure this, and who should be included, and to what degree. Those days of lack of regulation, of somehow the government is always the problem, always in the way, are over, and I would suggest that anybody who doesn't get that should just read any paper any day anywhere in America today.

Mr. Chairman, I yield back. Thank you.

The CHAIRMAN. The gentleman from South Carolina for 1½ minutes.

Mr. BARRETT. Thank you, Mr. Chairman.

Panel, recently we have been hearing a lot about a systemic risk regulator, but it is the details, guys, that matter. Before evaluating any proposal we need to know who that regulator will be, what the regulator will do, and who or what the regulator will oversee. We need reform, not more regulation. And we need to ensure that our current regulators are fulfilling their current mandates before we assign them new duties.

I look forward to hearing your insights on how we can ensure that any changes to the regulatory system can bring certainty and trust back into the economy, but do not prevent American families and small businesses from getting the capital that they sorely need.

I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman from Georgia, Mr. Price, for 1½ minutes.

Mr. PRICE. Thank you, Mr. Chairman. I am struck by the certitude of some of my friends on the other side of the aisle that may only be exceeded by their potential lack of appreciation for the dangers of a political economy. I would ask all of us to think about what industry is more regulated than the U.S. financial industry. Despite layers of regulation, we still find ourselves in the midst of a major economic contraction. We ought not lose sight of that fact.

I am extremely concerned with the idea of a systemic risk regulator. If a specific institution is designated as "systemically significant," it certainly sends the message that the government will not let it fail. This clearly gives these institutions a huge competitive advantage over nonsystemically significant institutions. This classification takes us even further into the realm of a political economy, and I would suggest that is the wrong road.

A market-based economy allows institutions to fail for a number of reasons. Allowing the government to prop up systemically significant institutions that would otherwise fail doesn't improve competition or efficiency in our financial system. This reminder should caution all of us as we consider a proposal that might potentially completely change the way our financial system operates, who wins, who loses and who decides.

I yield back.

The CHAIRMAN. The gentleman from Texas, Mr. Green, for 1½ minutes.

Mr. GREEN. Thank you, Mr. Chairman. Mr. Chairman, I believe that our affair with invidious laissez-faire is over. We don't expect football teams to regulate themselves, we don't expect self-regulation in basketball. I don't think that we can expect it in the economic order with reference to economic institutions. I believe that too big to fail is just right to regulate, because when we don't regulate too big to fail, the potential to decimate society exists. We have to have an Office of Systemic Risk Analysis if for no other reason than to identify institutions that are too big to fail so that they can be properly and positively regulated.

I yield back the balance of my time.

The CHAIRMAN. And finally, the gentleman from Texas, Mr. Neugebauer, for 1½ minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman, for holding these hearings.

A lot of changes are being proposed in the regulatory structure in our country, and we have to be very careful that we get this right. One of the questions that comes up is, did we have systemic risk because we didn't have the proper regulatory structure in place and the fact that there were holes in that system created systemic risk within our economy, or did we have systemic risk because we didn't have a systemic risk regulator? I will tell you that I believe that we have a regulatory structure that allowed systemic risk to begin to transpire in our economy. But quite honestly, I believe that the actions that we are taking today, unprecedented actions, are also creating major systemic risk in our economy.

What does this all point to? It all points to the fact that we must go very carefully and very slowly here as we look at reforming our financial markets because we have to get this right. Because some people believe if we get this right we will take risk out of the market. It is not the role nor can government take risk out of the market. But we can make sure that there is integrity and transparency in the market as we move forward.

And so, Mr. Chairman, I would hope that as we move down this road of regulatory reform, that we will be extremely careful here. It is not going to be the speed at which we do our work, but the quality of the work we do, because it is important to the American people that we get this right.

The CHAIRMAN. We will now begin the testimony in the order in which they are printed here, which is probably random, unlike the testimony. We will begin with Mr. Bartlett, Steve Bartlett, President and Chief Executive Officer of the Financial Services Roundtable, and a former member of this committee.

STATEMENT OF THE HONORABLE STEVE BARTLETT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FINANCIAL SERVICES ROUNDTABLE

Mr. BARTLETT. Thank you, Mr. Chairman.

Beginning about 3 years ago, the Roundtable began to examine the questions of our current regulatory system, many of which are raised today. This dialogue over that time has, over those 3 years, has evolved into a focus on how the current system also undermines the stability and the integrity of the financial services industry. I provided in my written testimony a format that provides at least our answer to many of the questions that were raised today and previously questions and comments. I want to summarize our conclusions as follows:

One, the financial services industry is regulated by hundreds of separate independent regulators at various levels. It is a system of fragmentation, inconsistency, and chaos. It is a fragmented system of national and State financial regulation that is based on functional regulation within individual companies, and those companies are also regulated according to their charter type. There is limited coordination and cooperation among different regulators even though firms with different charters often engage in the same,

similar, or sometimes exact activities. No Federal agency is responsible for examining and understanding the risk created by the interconnections between firms and between markets. This chaotic system, our conclusion, of financial regulation was a contributing factor to the current crisis.

Number two, that is not to say that the fragmented regulation is the only cause. The financial services industry accepts our share of responsibility: badly underwritten mortgages; compensation packages that pay for short-term revenue growth instead of long-term financial soundness; failure to communicate across sectors, even within the same company; and sometimes even downright predatory practices. All of those and more have been part of this crisis.

Since early 2007, the industry has formally and aggressively taken actions to correct those practices. Underwriting standards have been upgraded, credit practices have been reviewed and recalibrated, leverage has been reduced, and firms have rebuilt capital, incentives have been realigned, and some management teams have been replaced. We are not seeking credit for that. Clearly the horses are all out of the barn running around in the field. But those are the steps that have been taken in the last 2 years. But the regulatory system that was in place 2 years and 5 years ago is still in place. An absence of coherent comprehensive systemic regulatory structure did fail to identify and prevent the crisis, and we still have the same regulatory system today.

Number three, reforming and restructuring the regulatory system in 2009 should be Congress' primary mission moving forward to resolve the crisis and prevent another crisis. Achieving better and more effective regulation does require more than just rearranging regulatory assignments. Better and more effective regulation requires a greater reliance on principle-based regulation, a greater reliance on a system of prudential supervision, a reduction in the pro-cyclical effects of regulatory and accounting principles, and a consistent uniform standard of which similar activities and similar institutions are regulated in similar ways.

Number four, we are proposing a comprehensive reform of the regulatory structure that includes clear lines of authority and uniform standards across both State lines and types of business. Within our proposal, we recommend: the consolidation of several existing Federal agencies into single agencies, a single national financial institutions regulator that would be consolidated prudential and consumer protection agency for banking, securities, and insurance; a new capital markets agency through the merger of the SEC and the CFTC to protect depositors and shareholders and investors; and to resolve failing or failed institutions, we propose a creation of the national insurance and resolution authority to resolve institutions that fail in a consistent manner from place to place.

Number five, we also advocate a systemic regulator, what we prefer to call a market stability regulator. The market stability regulator would be, as I said in subcommittee testimony, "NIFO—nose in and fingers out." That means a market stability regulator should not replace or add to the primary regulators, but should identify risks and act through and with a firm's primary regulator. We believe that designating the Federal Reserve is the natural com-

plement to the Federal Reserve Board's existing authority as the Nation's central bank and the lender of last resort. The market stability regulator should be authorized to oversee all types of financial markets and financial services firms, whether regulated or unregulated, and we propose an exact definition of at least our proposal of that system of regulation of systemic regulator.

And number six, the U.S. regulatory system should be the U.S. system of course, but it should be coordinated and consistent with international standards.

Mr. Chairman, the time to act is now. We believe that these reforms should proceed in a comprehensive fashion rather than a piecemeal fashion. The key is to do this correctly, not rapidly, but to do this with the sense of urgency for which the crisis calls.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Bartlett can be found on page 64 of the appendix.]

The CHAIRMAN. I do note that our former colleague retains a respect for the 5-minute rule that we don't always get from witnesses, and I appreciate it.

Our next witness, a former official, Timothy Ryan, is here as the chief executive officer of the Securities Industry and Financial Markets Association.

STATEMENT OF THE HONORABLE T. TIMOTHY RYAN, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. RYAN. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee. My testimony will detail the Securities Industry and Financial Markets Association's view on the financial market stability regulator, including the mission, purpose, powers, and duties of such a regulator.

Systemic risk has been at the heart of the current financial crisis. While there is no single commonly accepted definition of systemic risk, we think of systemic risk as the risk of a systemwide financial breakdown characterized by a probability of the contemporaneous failure of a substantial number of financial institutions or of financial institutions or a financial market controlling a significant amount of financial resources that could result in a severe contraction of credit in the United States or have other serious adverse effects on global economic conditions or financial stability.

There is an emerging consensus among our members that we need a financial market stability regulator as a first step in addressing the challenges facing our overall financial regulatory structure. We believe that the mission of a financial market stability regulator should consist of mitigating systemic risk, maintaining financial stability, and addressing any financial crisis.

Specifically, the financial market stability regulator should have authority over all financial institutions in markets regardless of charter, functional regulator, or unregulated status. We agree with Chairman Bernanke that its mission should include monitoring systemic risk across firms and markets rather than only at the level of individual firms or sectors, assessing the potential for practices or products to increase systemic risk, and identifying regulatory gaps that have systemic impact.

One of the lessons learned from recent experience is that sectors of the market, such as the mortgage brokerage industry, can be systemically important even though no single institution in that sector is a significant player. The financial market stability regulator should have authority to gather information from all financial institutions and markets, adopt uniform regulations related to systemic risk, and act as a lender of last resort.

In carrying out its duties, the financial market stability regulator should coordinate with the relevant functional regulators, as well as the President's Working Group, in order to avoid duplicative or conflicting regulation and supervision. It should also coordinate with regulators responsible for systemic risk in other countries.

Although the financial market stability regulator's role would be distinct from that of the functional regulators, it should have a more direct role in the oversight of systemically important financial organizations, including the power to conduct examinations, take prompt corrective action, and appoint or act as the receiver or conservator of such systemically important groups.

These are more direct powers that would end if a financial group were no longer systemically important. We believe that all systemically important financial institutions that are not currently subject to Federal functional regulation, such as insurance companies and hedge funds, should be subject to such regulation. We do not believe the financial market stability regulator should play the day-to-day role for those entities. The ICI has suggested that hedge funds could be appropriately regulated by a merger of SEC and CFTC. We agree with that viewpoint.

The collapse of AIG has highlighted the importance of robust insurance holding company oversight. We believe the time has come for adoption of an operational Federal insurance charter for insurance companies. In a regulatory system where functional regulation is overlaid by financial stability oversight, how the financial market stability regulator coordinates with the functional regulators is an important issue to consider. As a general principle we believe that the financial markets regulator should coordinate with the relevant functional regulators in order to avoid duplicative or conflicting regulation and supervision. We also believe the Federal regulator for systemic risk should have a tiebreaker, should have the ultimate final decision where there are conflicts between the Federal functional regulators.

There are a number of options for who might be the financial market stability regulator. Who is selected as the financial stability regulator should have the right balance between accountability to and independence from the political process, it needs to have credibility in the markets and with regulators in other countries and, most importantly, with the U.S. citizens.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Ryan can be found on page 115 of the appendix.]

The CHAIRMAN. Thank you, Mr. Ryan.

Next, Peter Wallison, who is an Arthur F. Burns Fellow in Financial Policy Studies in the American Enterprise Institute and with whom I have a connection, because Mr. Burns and I—you may

not know this—are both from Bayonne, New Jersey. So I claim Mr. Burns as an alumnus.

Mr. Wallison.

STATEMENT OF THE HONORABLE PETER J. WALLISON, ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

Mr. WALLISON. Thank you, Mr. Chairman, and Ranking Member Bachus, for this opportunity to testify about a systemic risk regulator. There are two questions here, it seems to me. First, will a systemic regulator perform any useful function? And second, should a government agency be authorized to regulate so-called systemically significant financial institutions? I am going to start with the second question because I believe it is by far the most important.

Giving a government agency the power to designate companies as systemically significant and to regulate their capital and activities is a very troubling idea. It has the potential to destroy competition in every market where a systemically significant company is designated.

I say this as a person who has spent 10 years warning that Fannie Mae and Freddie Mac would have disastrous effects on the U.S. economy and that ultimately the taxpayers of this country would have to bail them out. Because they were seen as backed by the government, Fannie and Freddie were relieved of market discipline and able to take risks that other companies could not take. For the same reason, they also had access to lower cost financing than any of their competitors. These benefits enabled them to drive out competition and grow to enormous size. Ultimately, however, the risks they took caused their collapse and will cause enormous losses for U.S. taxpayers.

When Fannie and Freddie were taken over by the government, they held or guaranteed $1.6 trillion in subprime and Alt-A mortgages. These loans are defaulting at unprecedented rates, and I believe will ultimately cost U.S. taxpayers $400 billion. There is very little difference between a company that has been designated as systemically significant and a GSE like Fannie or Freddie. By definition a systemically significant firm will not be allowed to fail because its failure could have systemic effects. As a result it will be seen as less risky for creditors and counterparties and will be able to raise money at lower rates than its competitors. This advantage, as we saw with Fannie and Freddie, will allow it to dominate its market, which is a nightmare for every smaller company in every industry where a systemically significant company is allowed to operate.

Some will contend that in light of the failures among huge financial firms in recent months, we need regulation to prevent such things in the future, but this is obviously wrong. Regulation does not prevent risk-taking or loss. Witness the banking industry, the most heavily regulated sector in our economy. Many banks have become insolvent and many others have been or will be rescued by the taxpayers.

It is also argued that since we already have rescued a lot of financial institutions, moral hazard has been created, so now we should regulate all financial institutions as if they will be rescued

in the next crisis. But there is a lot of difference between de jure and de facto, especially when we are dealing with an unprecedented situation.

Anyone looking at the Fed's cooperation with the Treasury today would say that the Fed de facto is no longer independent. But after the crisis is over, we would expect that the Fed's independence will be reestablished. That is the difference between de jure and de facto.

Extending regulation beyond banking by picking certain firms and calling them systemically significant would, in my view, be a monumental mistake. We will simply be creating an unlimited number of Fannies and Freddies that will haunt our economy in the future.

Let me now turn to the question of systemic regulation in general. Why choose certain companies as systemically significant? The theory seems to be that the failure of big companies caused this financial crisis or without regulation might cause another in the future. But is the U.S. banking system in trouble today because of the failure of one or more large companies? Of course not. It is in trouble because of pervasive losses on trillions of dollars of bad mortgages. So will regulation of systemically significant companies prevent a recurrence of a financial crisis in the future? Not on the evidence before us. An external shock that causes asset prices to crash or investors to lose confidence in the future will have the same effect whether we regulate systemically significant companies or not. And regulation, as with banks, will not even prevent the failure of systemically significant companies; it will only set them up for bailouts when inevitably they suffer losses in their risk taking.

Finally, the Federal Reserve would be by far the worst choice for systemic regulator. As a lender of last resort, it has the power to bail out the companies it is supervising, without the approval of Congress or anyone else. Its regulatory responsibilities will conflict with its central banking role, and its involvement with the politics of regulation will raise doubts about its independence from the political branches.

We will achieve nothing by setting up a systemic regulator. If we do it at the cost of destroying faith in the dollar and competition in the financial services market, we will have done serious and unnecessary harm to the American economy.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Wallison can be found on page 159 of the appendix.]

The CHAIRMAN. Next, Terry Jorde, the president and CEO of CountryBank USA. She is here on behalf of the Independent Community Bankers of America.

STATEMENT OF TERRY J. JORDE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, COUNTRYBANK USA, ON BEHALF OF INDEPENDENT COMMUNITY BANKERS OF AMERICA (ICBA)

Ms. JORDE. Thank you, Mr. Chairman, Ranking Member Bachus, and members of the committee. My name is Terry Jorde. I am president and CEO of CountryBank USA. I am also immediate past chairman of the Independent Community Bankers of America.

My bank is located in Cando, North Dakota, a town of 1,300 people, where the motto is, "You Can Do better in Cando." CountryBank has 28 full-time employees and $45 million in assets. ICBA is pleased to have this opportunity to testify today on regulation of systemic risk in the financial services industry.

I must admit to you that I am very frustrated today. I have spent many years warning policymakers of the systemic risk that was being created in our Nation by the unbridled growth of the Nation's largest banks and financial firms. But I was told that I didn't get it, that I didn't understand the new global economy, that I was a protectionist, that I was afraid of competition, and that I needed to get with the modern times.

Well, sadly, we now know what the modern times look like, and it isn't pretty. Excessive concentration has led to systemic risk and the credit crisis. Banking and antitrust laws are too narrow to prevent these risks. Antitrust laws are supposed to maintain competitive geographic and product markets. So long as the courts and agencies can discern that there are enough competitors in a particular market, that ends the inquiry. This often prevents local banks from merging, but it does nothing to prevent the creation of giant nationwide franchises.

Banking regulation is similar. The agencies ask only if a given merger will enhance the safety and soundness of an individual firm. They generally answer bigger is almost necessarily stronger. A bigger firm can, many said, spread its risk across geographic areas and business lines. No one wondered what would happen if one firm or a group of firms jumped off a cliff and made billions in unsound mortgages.

Now we know; our economy is in crisis. The four largest banking companies control more than 40 percent of the Nation's deposits and more than 50 percent of U.S. bank assets. This is not in the public interest. A more diverse financial system would reduce risk and promote competition, innovation, and the availability of credit to consumers of various means and businesses of all sizes.

We can prove this. Despite the challenges we face, the community bank segment of the financial system is still working and working well. We are open for business, we are making loans, and we are ready to help all Americans weather these difficult times.

But I must report that community bankers are angry. Almost every Monday morning, they wake up to news that the government has bailed out yet another too big to fail institution. On many Saturdays, they hear that the FDIC summarily closed one or two too small to save institutions. And just recently, the FDIC proposed a huge special premium to pay for losses imposed by large institutions. This inequity must end, and only Congress can do it. The current situation will damage community banks and the consumers and small businesses that we serve.

What can we do? ICBA recommends the following strong measures: Congress should direct a fully staffed interagency task force to immediately identify systemic risk institutions. They should be put immediately under Federal supervision. The Federal systemic risk agency should impose two fees on these institutions that would compensate the agency for the cost of supervision and capitalize a systemic risk fund comparable to the FDIC. The FDIC should im-

pose a systemic risk premium on any insured bank that is affiliated with a systemic risk firm. The systemic risk regulator should impose higher capital charges to provide a cushion against systemic risk.

The Congress should direct the systemic risk regulator and the FDIC to develop procedures to resolve the failure of a systemic risk institution. The Congress should direct the interagency systemic risk task force to order the breakup of systemic risk institutions. Congress should direct the systemic risk regulator to block any merger that would result in the creation of a systemic risk institution. And finally, it should direct the systemic risk regulator to block any financial activity that threatens to impose a systemic risk.

The current crisis provides you an opportunity to strengthen our Nation's financial system and economy by taking these important steps. They will protect taxpayers and create a vibrant banking system where small and large institutions are able to fairly compete. ICBA urges Congress to quickly seize this opportunity.

Thank you, Mr. Chairman.

[The prepared statement of Ms. Jorde can be found on page 91 of the appendix.]

The CHAIRMAN. Thank you. And next, we have Mr. Travis Plunkett, the legislative director of the Consumer Federation of America.

STATEMENT OF TRAVIS PLUNKETT, LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

Mr. PLUNKETT. Thank you, Mr. Chairman, Ranking Member Bachus, and members of the committee. I am Travis Plunkett, legislative director of the Consumer Federation of America, and I appreciate the opportunity to testify today about how to better protect the financial system as a whole and the broader economy from systemic risk. I would like to make three key points:

First, systemic regulation isn't just a matter of designating and empowering a risk regulator, as important as that may be. It involves a comprehensive plan to reduce systemic risk, including immediate steps both to reinvigorate day-to-day safety and soundness in consumer and investor protection regulation of financial institutions and to address existing systemic risk, in particular by shutting down the shadow banking system once and for all.

Second, systemic risk regulation should not rely only on a crisis management approach or focus on flagging a handful of large institutions that are deemed too big to fail. Rather, it must be an ongoing day-to-day obligation of financial regulators focused on reducing the likelihood of a systemic failure triggered by any institution or institutions in the aggregate.

Third, CFA has not endorsed a particular systemic regulatory structure, but if Congress chooses to designate the Fed as a systemic regulator, it must take steps to address several problems inherent in this approach, including the Fed's lack of transparency and accountability and the potential for conflicts between the roles of setting monetary policy and regulating for systemic risk.

The fact that we could have prevented the current crisis without a systemic regulator provides a cautionary lesson about the limits

of an approach that is just focused on creating new regulatory structures. It is clear that regulators could have prevented or greatly reduced the severity of the current crisis using basic consumer protection and safety and soundness authority. Unless we abandon a regulatory philosophy based on a rational faith in the ability of markets to self-correct, whatever we do on systemic risk regulation is likely to have a limited effect.

The flip side of this point, the positive side, suggests that simply closing the loopholes in the current regulatory structure, reinvigorating Federal regulators in doing an effective job of the day-to-day task of soundness and investor and consumer protection will go a long way to eliminating the greatest threats to the financial system.

Chairman Frank and several members of this committee have been leaders in talking about the importance of a comprehensive approach to systemic risk regulation and have focused on executive compensation as a factor that contributes to systemic risk. We agree about the compensation practices that encourage excessive risk-taking and about the need to bring currently unregulated financial activities under the regulatory umbrella.

The experiences of the past year have demonstrated conclusively the ineffectiveness of managing systemic risk only when the Nation finds itself on the brink of a crisis. It is of paramount importance in our view that any new plan provide regulators with ongoing day-to-day authority to curb systemic risk.

The goal of regulation should not be focused only or even primarily on the potential bailout of systemically significant institutions. Rather, it should be designed to ensure that all risks that could threaten the broader financial system are quickly identified and addressed to reduce the likelihood that a systemically significant institution will fail and to provide for the orderly failure of nonbank financial institutions.

Regardless of which structure Congress chooses to adopt, we urge you to build incentives into the system to discourage institutions from becoming too big or too interconnected to fail. One way to do this is to subject financial institutions to risk-based capital requirements and premium payments designed to deter those practices that magnify risks, such as growing too large, holding risky assets, increasing leverage, or engaging in other activities deemed risky by regulators.

To increase the accountability of regulators and reduce the risk of groupthink, we also recommend that you create a high level systemic risk advisory council made up of academics and other independent analysts from a variety of disciplines.

Once again, I appreciate the opportunity to appear before you today and look forward to answering questions.

[The prepared statement of Mr. Plunkett can be found on page 101 of the appendix.]

Mr. KANJORSKI. [presiding] Thank you very much, Mr. Plunkett. Mr. Silvers.

STATEMENT OF DAMON A. SILVERS, ASSOCIATE GENERAL COUNSEL, AFL–CIO

Mr. SILVERS. Thank you, Congressman Kanjorski. Good morning, and good morning to Ranking Member Bachus and the committee. My name is Damon Silvers. I am associate general counsel of the AFL–CIO, and I am the deputy chair of the Congressional Oversight Panel. My testimony today though is on behalf of the AFL–CIO, and though I will refer to the work of the panel on which I am honored to serve together with Congressman Hensarling, my testimony does not reflect necessarily the views of the panel, its chair, or its staff.

The AFL–CIO has urged Congress since 2006 to act to reregulate shadow financial markets, and the AFL–CIO supports addressing systemic risk. The Congressional Oversight Panel made the following recommendations with respect to addressing systemic risk, recommendations which the AFL–CIO supports:

First, there should be a body charged with monitoring sources of systemic risk in the financial system. The AFL–CIO believes that systemic risk regulation should be the responsibility of a coordinating body of regulators chaired by the Chairman of the Board of Governors of the Federal Reserve System. This body should have its own staff with the resources and expertise to monitor diverse sources of systemic risk in institutions, products, and markets throughout the financial system.

Second, the body charged with systemic risk management should be a fully public body, accountable and transparent. The current structure of regional Federal Reserve banks, the institutions that actually do the regulation of bank holding companies, where the banks participate in the governance, is not acceptable for a systemic risk regulator.

Third, we should not identify specific institutions in advance as too big to fail but, rather, have a regulatory framework in which institutions have higher capital requirements and pay more on insurance funds on a percentage basis than smaller institutions which are less likely to be rescued as being too systemically significant.

Fourth, systemic risk regulation cannot be a substitute for routine disclosure, accountability, safety and soundness, and consumer protection regulation of financial institutions and financial markets. Consequently, the AFL–CIO supports a separate consumer protection agency for financial services rather than having that authority rest with bank regulators. And here we see this consumer protection function as somewhat distinct from investor protection, which the SEC should do.

Fifth, effective protection against systemic risk requires that the shadow capital markets, institutions like hedge funds and private equity funds and products like credit derivatives, must not only be subject to systemic risk-oriented oversight, but must also be brought within a framework of routine capital market regulation by agencies like the SEC. We can no longer tolerate a Swiss cheese system of financial regulations.

And finally, there will not be effective reregulation of the financial markets without a global regulatory floor. That ought to be a primary goal of the diplomatic arms of our government.

The Congressional Oversight Panel urged that attention be paid to executive compensation in financial institutions. This is an issue of particular concern to the AFL–CIO that I want to turn to now in the remainder of my testimony in relation to systemic risk.

There are two basic ways in which executive pay can be a source of systemic risk. When financial institutions' pay packages have short-term pay horizons that enable executives to cash out their incentive pay before the full consequences of their actions are known, that is a way to generate systemic risk.

Secondly, there is the problem that is technically referred to as risk asymmetry. When an investor holds a stock, the investor is exposed to upside and downside risk in equal proportion. For every dollar of value lost or gained, the stock moves proportionately; but when an executive is compensated with stock options, the upside works like a stock but the downside is effectively capped. Once the stock falls well below the strike price of the option, the executive is relatively indifferent to further losses. This creates an incentive to focus on the upside and be less interested in the possibility of things going really wrong. It is a terrible way to incentivize the managers of major financial institutions, and a particularly terrible way to incentivize the manager of an institution the Federal Government might have to rescue.

This is highly relevant, by the way, to the situation of sick financial institutions. When stock prices have fallen close to zero, stocks themselves behave like options from an incentive perspective. It is very dangerous to have sick financial institutions run by people who are incentivized by the stock price. You are basically inviting them to take destructive risks, from the perspective of anyone like the Federal Government, who might have to cover the downside.

This problem today exists in institutions like AIG and Citigroup, not just with the CEO of the top five executives, but for hundreds of members of the senior management team.

A further source of assymetric risk incentive is the combination of equity-based compensation with large severance packages. As we have learned, disastrous failure in financial institutions sometimes leads to getting fired but rarely leads to getting fired for cause. The result is the failed executive gets a large severance package.

If success leads to big payouts and failure leads to big payouts but modest achievements either way do not, then there is a big incentive to shoot the moon without regard to downside risk. These sorts of pay packages in just one very large financial institution can be a source of systemic risk, but when they are the norm throughout the financial services sector, they are a systemwide source of risk, much like unregulated derivatives or asset-backed securities. Consequently, this is an issue that the regulators of systemic risk ought to have the authority to take up.

I thank you for your time.

[The prepared statement of Mr. Silvers can be found on page 136 of the appendix.]

The CHAIRMAN. Thank you.

Finally, Edward Yingling, who is the president and CEO of the American Bankers Association.

STATEMENT OF EDWARD L. YINGLING, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN BANKERS ASSOCIATION (ABA)

Mr. YINGLING. Thank you, Mr. Chairman, Ranking Member Bachus, and members of the committee. The ABA congratulates this committee on the approach it is to taking to the financial crisis. There is a great need to act, but to do so in a thoughtful and thorough manner and with the right priorities. That is what this committee is doing.

Last week, Chairman Bernanke gave a speech which focused on three main areas: First, the need for a systemic risk regulator; second, the need for a method of orderly resolution of systemically important financial firms; and third, the need to address gaps in our regulatory system.

Statements by the leadership of this committee have also focused on a legislative plan to address these three areas. We agree that these three issues: A systemic regulator; a new resolution mechanism; and addressing gaps, should be the priorities. This terrible crisis should not be allowed to happen again, and addressing these three areas is critical to make sure it does not.

The ABA strongly supports the creation of a systemic regulator. In retrospect, it is inexplicable that we have not had such a regulator.

To use a simple analogy, think of a systemic regulator as sitting on top of Mount Olympus, looking out over the land. From that highest point, the regulator is charged with surveying the land, looking for fires. Instead we have had a number of regulators, each of which sits on top of a smaller mountain and only sees part of the land. Even worse, no one is effectively looking over some areas.

While there are various proposals as to who should be the systemic regulator, most of the focus has been on giving the authority to the Federal Reserve. It does make sense to look for the answer within the parameters of the current regulatory system. It is doubtful that we have the luxury, in the midst of this crisis, to build a new system from scratch, however appealing that might be in theory.

There are good arguments for looking to the Fed. This could be done by giving the authority to the Fed or by creating an oversight committee chaired by the Fed. ABA's one concern in using the Fed relates to what it may mean for the independence of the Federal Reserve in the future. We strongly believe in the importance of Federal Reserve independence in setting monetary policy.

ABA believes that systemic regulation cannot be effective if accounting policy is not part of the equation. That is why we support the Perlmutter-Lucas bill, H.R. 1349.

To continue my analogy, a systemic regulator on Mount Olympus cannot function if part of the land is held strictly off limits and under the rule of some other body, a body that can act in a way that contradicts the systemic regulator's policies. That is, in fact, exactly what happened with mark-to-market accounting.

I want to take this opportunity to thank this committee for the bipartisan efforts in the hearing last week on mark-to-market. Your efforts last week will significantly aid in economic recovery.

We hope that the FASB and the SEC will take the final action you clearly advocated.

ABA strongly supports a mechanism for the orderly resolution of systemically important nonbank firms. Our regulatory body should never again be in a position of making up a solution to a Bear Stearns or an AIG or not being able to resolve a Lehman Brothers. The inability to deal with those situations in a predetermined way greatly exacerbated this crisis.

A critical issue in this regard is too-big-to-fail. Whatever is done on the systemic regulator and on a resolution system will in a major fashion determine the parameters of too-big-to-fail. In an ideal world, there would be no such thing as too-big-to-fail; but we know that the concept not only exists, it has grown broader over the last few months. This concept has profound moral hazard and competitive effects that are very important to address.

The third area of our focus is where there are gaps in regulation. These gaps have proven to be a major factor in the crisis, particularly the role of largely unregulated mortgage lenders. Credit default swaps and hedge funds should also be addressed in legislation to close gaps.

There seems to be a broad consensus to address these three areas. The specifics will be complex and in some cases contentious. At this very important time, with Americans losing their jobs, their homes and their retirement savings, all of us should work together to develop a stronger regulatory structure. The ABA pledges to be an active and constructive participant in this critical hour.

Thank you.

[The prepared statement of Mr. Yingling can be found on page 171 of the appendix.]

The CHAIRMAN. Thank you all. This is all very useful, and I think we are having—I mean, we have a crisis, and the crisis is not conducive to kind of calmness, and I am pleased that we appear to be able to separate that out, and we deal with the crisis under a lot of sturm und drang. We can have rational conversations about where to go forward. I appreciate everybody's approach.

A couple of brief points. Ms. Jorde, as you know, if we are able to get through the Senate, and we would then concur an increase in the FDIC's lending authority to deal with potential problems up to the $500 billion mark, the increase in the assessment will be substantially reduced. They are talking now about a 13-cent increase, and it would go down to a 3-cent increase.

So that is on the community banks, as you correctly point out, being hit with the assessment that is based on some others. Whether or not that should be risk-based, many of us think it is. If that could be worked out, that is separate. But we are on track, I think it is now 6.3 cents. Instead of going to 20 cents, it would go to 10 cents, which is a very substantial reduction, and we will try to do that.

Mr. Wallison, on the insurance issue, an important one, you mentioned the problem with the regulated AIG entities, the insurance companies. Then the money went to an unregulated entity. And you said an optional Federal charter, and that would be very much on the agenda of this committee. There are members who have pushed for it.

But what would you do for those who opted not to opt? Would you give some Federal power—and you pointed out a problem here that, with AIG, you had regulated companies but an unregulated entity on the top. If you had an optional Federal charter and the entity became a Federal charter that could be federally regulated, what would you do for situations where the companies did not opt for Federal charter? Would you extend some Federal regulation at that top level?

Mr. WALLISON. First of all, Mr. Chairman, AIG is regulated. It is regulated by OTS. It is a thrift holding company. Now, it might not have been effectively—

The CHAIRMAN. Well, I thought you were calling—maybe I misunderstood your testimony. I thought you were calling for a change and saying that we should have an optional Federal charter that should improve regulation of insurance. I apologize if I misinterpreted that.

Mr. WALLISON. I didn't actually speak about an optional Federal charter. I happen to favor that, but I didn't speak about it in this testimony.

The CHAIRMAN. Oh, it is Mr. Ryan. I apologize.

Mr. WALLISON. We look so much alike, I guess.

The CHAIRMAN. From here, I apologize then. Let me ask that to Mr. Ryan. I am sorry, Mr. Wallison.

Mr. RYAN. The direct answer is that if a company did not opt for a Federal charter, but it was systemically important or involved in systemically important activities, then under our proposal the regulator would have authority.

The CHAIRMAN. So is that an option of—the Federal charter would be the Federal insurance regulator, but it would go up.

Let me ask one other issue, and Mr. Silvers made an important point about the compensation. And I have one other question that I hear everybody talking about, and that is, it is my impression that part of the problem—Mr. Yingling mentioned the subprime loans—if enough bad decisions are made at the outset, it seems to me it is very hard to recover from that. The ability to securitize 100 percent of the loans appears to me to be part of the problem. Should we explore some limitation on the ability to securitize? Should there be some risk-retention requirement in that area?

Mr. Bartlett, let's begin with you.

Mr. BARTLETT. We concluded—and this is a reversal of our previous position—that there should be some risk retention. We think that is going to happen in Europe, and it is the prudent thing to do, risk retention of some type.

The CHAIRMAN. Mr. Ryan.

Mr. RYAN. We think it is practical that, at least here and in Europe, there will be some risk retention. So we are cozied up to that requirement. How much, we are still debating.

The CHAIRMAN. I agree with both. How much, and is it first dollar or what percentage? Is it proportional? I mean, obviously saying that, but that begins an inquiry. Mr. Wallison.

Mr. WALLISON. I think there is good reason to at least make sure that someone is bearing a risk at every level, but we also ought to, Mr. Chairman, begin to look at other methods of financing our mortgage system, covered bonds, for example.

The CHAIRMAN. I agree with that, and we will be getting to that, but I did want to give—and I appreciate that. Ms. Jorde.

Ms. JORDE. I certainly can understand the philosophy of retaining risk. I think the one caveat would be how that would affect the community banking industry in terms of servicing. For example, we don't have the mortgage departments geared up to handle servicing, so most of the banks of my size will sell their mortgages with servicing released. I guess it would be whether or not the economies of scale would be sufficient enough that community banks would be able to continue to participate in that market.

The CHAIRMAN. Well, thank you. It is theoretically possible that you could still sell off the servicing but retain a small percentage of the risk?

Ms. JORDE. Certainly.

The CHAIRMAN. Mr. Plunkett.

Mr. PLUNKETT. Yes. We would support additional risk-retention requirements for securitization. And Mr. Chairman, on the question of an optional Federal charter, it just seems like a valuable lesson of the current crisis. If we have learned anything, it is that giving the regulated party their choice of regulator will lead to downward pressure on bank quality.

The CHAIRMAN. Thank you. I do want to get to Mr. Silvers.

Mr. SILVERS. Yes, I think that risk—retaining some skin in the game is a good idea, but not just for the originator. I think there has been a lot of learning about how damaging it has been that servicers, say in mortgages, are disconnected from the economics of the mortgage. And I think—

The CHAIRMAN. I appreciate it. The gentlewoman from California is here, and she, early on, focused on the problem in the servicer model, and over and above the risk retention, but in dealing with the whole question of mortgages, I believe we will—it seems to me it is a great mistake for the law to allow important decisions that have to be made but can't be made; that they should not be in a situation where nobody is in charge of some important decisions. And we will approach that.

Mr. Yingling, on the risk retention.

Mr. YINGLING. I would agree with your analysis, and I know you are well aware there are some very thorny accounting issues that we have to work our way through, but it is something we definitely all ought to look at to see if we can't make people have some skin in the game.

The CHAIRMAN. I thank the witnesses. The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman.

Let me pick up on Mr. Yingling's analogy of the systemic risk regulator sitting up on Mount Olympus, you know, surveying the scene, putting out the fires. And one of my problems is that we are—he wouldn't put out all the fires. He would only put out the big fires, as I understand it. Is that correct?

Mr. YINGLING. That is correct; and more importantly, identify the fires and then decide who puts out the fires.

Mr. BACHUS. The little fires would be allowed to burn?

Mr. YINGLING. To some degree; or the regulator on the smaller mountain would be in charge of that.

Mr. BACHUS. But to me, that is one of the really unfair aspects of too-big-to-fail. It implies—and I have said this since September—it implies too-small-to-save. And as we say in Alabama, this is just flat-out unfair, and we seem to be endorsing, with legislation, a regulatory approach like that.

The other thing is that you have a regulatory agency sitting up there on Mount Olympus, and they are not only putting out fires, but they are also repairing the structures at taxpayer expense. I mean, they go in and they are doing it with taxpayer dollars. And is that wrong? Or should we—you know, I said in my opening statement, let's try to agree on something going in, so that we don't have these multibillion-dollar taxpayer bailouts.

I ask all the panelists, what is your position on giving the regulator—and all we are basing that on right now is a Federal Reserve Act, some language in there, and—but let me just start with you, Mr. Bartlett. Do you think that we ought to empower this—the risk regulator to use billions of dollars' worth of taxpayer money.

Mr. BARTLETT. No, Congressman, I don't; other than what we now have, which is no analysis of systemic risk, no oversight of systemic risk, no one to notice systemic risk and the unlimited Federal Reserve dollars. So none of the systemic risk regulator proposals propose any additional authority on the solution problem.

What we have proposed is the Federal Reserve as a systemic risk oversight, but then followed by a coherent, comprehensive resolution authority to resolve the failures in a coherent, consistent manner that does not now exist.

Mr. BACHUS. I would agree with that and advance a resolution, but I think we ought to put a provision in there that they don't use taxpayer dollars.

Another thing that I think—what do you think about advancing local lending more? In the past several years with the consolidation, we are getting further away from sort of Main Street lending. Is that a problem?

Mr. BARTLETT. Congressman, I don't see it that way. I think lending is up. I think that the lending from all sizes of banks, both largest and smallest, is actually up. Regions in Birmingham and Compass Bank in Birmingham have, in fact, increased their lending. Whitney has increased their lending. So it is not size that either causes more commercial lending or less. It is the capital underneath at the bank. So I don't see it as a size issue.

Mr. BACHUS. Of course, size is an issue when it comes to too-big-to-fail I guess.

Mr. BARTLETT. We haven't seen—we are not ones who agree with too-big-to-fail.

Mr. BACHUS. Oh, okay.

Mr. BARTLETT. Wachovia failed, WAMU failed, National City failed. The issue is whether we can identify and prevent the problems earlier and then whether the resolution can be done in an orderly way.

Mr. BACHUS. And I am on board with all that.

Although I have to agree with Mr. Wallison, and I preface that by saying, could this be an incentive to take even more risk? I mean, when you have a perception out there that you have a government agency that is going to make sure that an institution

doesn't fail, as he said, you identify them as systematically important. You are implying that there is some sort of guarantee. Now, even if you don't give it, we saw that in Fannie and Freddie as soon as they began to fail, we all said there was an implicit guarantee.

Mr. Wallison, do you—is there any way—without just simply saying that we are not—that the government is not going to bail these companies out, I don't see any way to avoid at least an implicit guarantee, which I think we have learned is a bad thing.

Mr. WALLISON. I think you are correct, Mr. Bachus. The markets are very clear about this sort of thing. And where the government seems to be backing a company in some way and making sure that the company will not fail through government resources, then the market follows that lead, and they will make it easier for these companies to raise Funds, and at lower rates than others they compete with. So we will have a Fannie and Freddie situation to deal with in every market.

Mr. BACHUS. I think the government can guarantee things, and that is Treasury bonds and debt obligations of the U.S. Government, and that is where it ought to end. And if people think they are investing in something the government is going to back, they ought to invest in government bonds or securities or instruments.

Ms. JORDE. Congressman Bachus, to go back to your fire analogy, I think really what we are looking at is whether we need a big, huge, large fire department, and I don't think that is what we are talking about here. I think we need to figure out ways to keep these fires from starting.

You know, if you look at the national—at the systemic risk of some of these largest institutions and the national dependence on those, I would question whether or not the—on failure of AIG and Bear Stearns, you know, if they had been allowed to go down, what would the impact have been on Citicorp and Bank of America? I mean, I think that is really what we are talking about is the interconnectedness of these huge financial institutions that are too large and they can't fail, and if they do, everything else goes down with them. So we have to keep the fires from starting.

Mr. BACHUS. Sure, and that was his analogy. That was Mr. Yingling's analogy. But I appreciate that, and I agree with you.

I think that is the—but once they start, I don't think the government ought to put them out at taxpayer expense unless we have guaranteed deposits, and that is where it ought to end. We ought to guarantee deposits. Whether that level is $250,000 or $500,000, it ought to end wherever that guarantee ends.

Mr. KANJORSKI. [presiding] Thank you very much, Mr. Bachus. I will take my 5 minutes while we are waiting for the Chair to return.

First of all, let me thank the panel for their testimony and for their unanimous support of having skin in the game. That really is a revolutionary concept that we would have seven members of panelists, diverse as this panel is, and everybody agreeing. It is time we do put skin in the game. I think it is very responsible for us to do that.

Mr. Yingling, I think that you have made an observation to this committee on these issues that we have attempted to, as best as

possible, remove ourselves from the temptation of talking to political issues but, in fact, look at these questions in a much more bipartisan way and I hope that continues.

And if it does, I would think that to a large extent we may be able to get some progress yet unappreciated by the general public.

On that question, though, of systemic risk, I am still one of the slight doubters. It sounds to me that it is structured to be able to say, "so this shall never happen again," and every time I hear that phrase, I shudder because we all know it is not going to happen in the same way. This is capitalism's attempt to escape the confines of control and regulation that proved very healthy for 80 years, until in the last decade the escape was there. And I think it has a lot to do with the unregulated banking system that allowed this leveraging to occur, allowed the situation to get out of hand to the extent that I think most of us saw this potential happening maybe 2005, 2006, that it was going to be clear something was going to happen that was not necessarily intended or desirable for the public.

Now my question is, though, so that we do not run down this road very quickly to create a "systemic risk regulator," have you all given deep thought as to what powers a systemic risk regulator would have to have and how deep could they go, and what could they inquire into, and that it would not necessarily be limited just to "financial institutions," it would go into other institutions?

Because as you all may recall, just several weeks ago, we had the auto industry in here testifying to the fact that they were going to be a systemic risk situation, because if any one of the three American auto manufacturers were to go down, it would bring the other two down because it constituted systemic risk insofar as they were coordinated and intertwined with their dealers and with their suppliers. And it has almost been a given up until this time that if one company goes down, all three American companies go down, and possibly even the entire industry. Even foreign manufacturers in the United States would be gravely if not totally disadvantaged by that occurrence.

Now that being the case, and adding to that, that there is a financial structure that exists in the auto industry; that is, the arms of financing—Chrysler Financial and GMAC and Ford Financial—again, blend right into the fact—I don't know, is this—would you all consider the automobile manufacturing companies just auto manufacturing, or are they financial institutions, or are they an ugly blend of the two that are very difficult to separate, if not impossible to separate? That is just a side question.

But now, how far do you want us to go down this path of empowering a "systemic risk regulator" who would have to have tremendous information, almost clairvoyance, in terms of determining what the ambitions of certain people in the financial market were, to determine whether at some future event these actions that were contemplated would cause systemic risk? Anybody who wants to—

Mr. SILVERS. Congressman, I think there are three ways of answering your question.

First, if we are going to be serious about watching systemic risk across the financial system, in a realm where people innovate—and the people who do most of the innovating in this area are lawyers—

then you really do have to have a pretty sort of comprehensive writ of authority to look where you need to look. GE Capital is clearly an institution capable of generating systemic risk, although GE is a manufacturing enterprise.

Secondly, though this is not sufficient, I think much of the problem here in terms of shadow markets comes from not giving routine regulators the ability to follow the action, and I think that it will be very difficult for some of the reasons you were alluding to, to capture the full range of market activity if the day-to-day regulators don't have the kind of broad jurisdiction that they enjoyed in the post-New Deal era and that was taken away gradually over the last 20 years or so.

But there is a trick here, and I am not sure what the answer to it is, but I think the committee ought to be well aware of it. It is one thing to give oversight and surveillance power; it is another thing to give the systemic risk regulator the ability to override judgments of day-to-day regulators, and particularly this is true in relation to investor and consumer protection. There is a natural and unavoidable tension between anyone charged with essentially the safety and soundness of financial institutions and agencies charged with transparency and investor protection and consumer protection. That tension has always been there. If you give a systemic risk regulator the authority to hide things, there is a real danger they will use it, and that will actually not—that will actually not protect us against systemic risk but, rather, do the opposite.

Mr. KANJORSKI. Mr. Yingling.

Mr. YINGLING. First, Congressman Kanjorski, I really want to thank you for your efforts last week in holding that a hearing on mark-to-market. It was so important.

I think from our point of view, the systemic regulator has somewhat limited authority in the sense that they—that the regulator can broadly look and have information, but we don't see that as the ultimate authority, the regulator of regulators. So that primarily it is an information gatherer, and has some ability to go in and say, okay, we have a problem, now let's coordinate it.

But one part of this equation that I think gets too little emphasis is the method for resolving systemic failures in the future. That is so important. If you look at the mess we are in today, a lot of it is because we did not have a good system for resolving—let's take the big example, AIG. We had a system for resolving Wachovia and WAMU, and I think if we really focus our efforts on getting that resolution mechanism there in advance, it not only affects how you resolve institutions, it has ripple effects back on what it may mean or not mean to be too-big-to-fail. And so that resolution mechanism is very, very important in all of this.

Mr. KANJORSKI. Very good point. Yes, Mr. Wallison?

Mr. WALLISON. Thank you, Congressman. Your point about auto manufacturers, I think, suggests how plastic and unclear this whole idea of systemic risk really is. We all talk about it as though it is something that we understand. But it is highly theoretical, and we don't really have an example yet of systemic risk being created by anything other than, as I said in my oral testimony, any-

thing other than some kind of external factor affecting the entire market.

The market—the financial system around the world, and especially in the United States—is seriously troubled now, but not because of the failure of any particular company; rather, because of all of the bad mortgages that were spread throughout the world. Regulation did not prevent that from happening. We had a very strong regulatory system in place. The banks were subject to it.

FDICIA, which I think you would remember well from your service here at the time, was intended to be the end of all bad banking crises. It is a very strong law, and yet we now have the worst banking crisis of all time.

So I think before Congress acts on the question of systemic risk, there ought to be some understanding of what we are really talking about. Because if an agency is empowered to regulate systemic risk—it could apply to auto manufacturers as well as anyone else—Congress is handing over a blank check to a government agency, and that would be a very bad precedent.

Mr. KANJORSKI. Thanks. I know I am taking up a little extra time, but I think your answers are important for us to get.

Mr. RYAN. I would like to make a comment that goes to the chairman's question and your comment about the uniqueness of all of us having a view on retention, and put this in perspective.

Securitization, as the chairman noted, is an essential ingredient in how we provide financing for consumers in this country. In 2007, about $2.8 trillion. We are now inching along at very little; the business is basically dormant. So when people are complaining about credit availability for consumers, a large part of that is because securitization is basically dormant.

As you approach whatever you are going to be doing on securitization, I would urge you to think through not only the retention issue—and retention is very complicated, how much, by whom—and we all know what we are trying to achieve here, which is basically to incent people such that they are not originating or underwriting for assets. But when you look at retention, think more broadly. Think about transparency. Think about how these securities are structured, valuation. Think also about the credit rating agencies, because that is an integral part of fixing this situation. We need modification there. Thank you.

Mr. KANJORSKI. Thank you. No one else? Oh, yes.

Ms. JORDE. Thank you. I think one more thing that is important to consider when we look at systemic risk is that it is being exacerbated as we move toward more mixing of banking and commerce. We refer to the auto manufacturers, but the auto manufacturers are also making mortgage loans and financing their own vehicles. We talk about GE Capital and GE. You know, as we have moved towards more mixing of banking and commerce, certainly we are creating more systemic risk. It was what ruined the Japanese financial system back in the 1990's, and it is something that we need to look very closely at as we move forward; close the IOC loophole and keep banking and commerce separate.

Mr. KANJORSKI. Thank you very much. Mr. Royce, I am sorry I took the extra time.

Mr. ROYCE. Thank you, Mr. Chairman. I wanted to just start with the observation that it was Mr. Wallison who warned us many years ago about the systemic risk to the broader financial system. In 1992, we passed the GSE Act in Congress, and as a consequence of passing that Act, we set up goals, affordable housing goals, and when the Federal Reserve looked at the consequences of that, they began to see the same thing that Mr. Wallison saw, and they sought to get Congress involved in this because, as was observed, banks are regulated and so they can only leverage 10 to 1, right?

But we were allowing Fannie Mae and Freddie Mac to leverage 100 to 1 and to go into arbitrage, and the reason they were allowed to do that was because there was an attempt to have them meet these goals. Somebody had to buy those subprimes from Countrywide, and it was Fannie and Freddie that had the requirement in terms of the goals to buy these subprime loans and these faulty loans.

In 2005, I brought an amendment to the Floor of the House of Representatives to regulate these GSEs or to allow the Fed and allow OFHEO, allow the regulator to regulate them for systemic risk, because the regulator had asked for this ability to regulate them for systemic risk to the wider financial system. And at that time that amendment was voted down.

In the meantime, as you know, we also passed legislation here that allowed the government basically to bully the market, to bully the banks in terms of the types of loans that they would make, and to rig the system so that originally what was 20 percent down became 10 percent down, became 3 percent down, became 0 percent down, because we had to meet those goals for very-low-income and low-income affordable housing.

Now, the reason I think it is important that Mr. Wallison be here is because through all of this debate, he and the Federal Reserve were the ones coming up here warning us that because of the power they had in the market they were crowding out the competition. They were becoming the majority holder of and purchasers of these mortgage-backed securities, securitization. They were the market. And as a consequence of the risks they were taking and the excessive leverage, we had a situation where it was helping to balloon the market and create a situation where once these standards had been lowered, 30 percent of the market participants were now flippers. In other words, we did it for a good cause, Congress did it for a good cause. We lowered these standards. We pushed affordable housing. But we forgot, or some of us forgot, that flippers would come in and take advantage of those new 3 percent down or 0 percent down programs and would be able to eventually constitute 30 percent of the entire market, which is what happened come 2005, according to the Federal Reserve, 2006, 2007, and that further, of course, you know ballooned up this problem.

Now, understanding the potential implications of labeling certain companies as systemically significant, as you explained in your testimony, Mr. Wallison, do you believe it is important to take steps in overhauling our regulatory structure because, you know, the previous Treasury Secretary issued this Blueprint for Regulatory Reform in March of last year, and in many respects, at least from my perspective, that would close systemic gaps in the system. It

merged duplicative regulatory bodies. It ended those who were redundant, who weren't necessary anymore as a result of consolidating them, and central in that Treasury plan was that in many respects banks, security firms, insurance companies, actually represent a single financial services industry, not three separate industries, and ought to be regulated as such. And these firms are all competing with one another and, as long as this is true, it makes no sense to regulate them separately from the standpoint of Treasury. While the Treasury Blueprint was not perfect, I believe it was a step in the right direction.

It is important this this Congress not talk about systemic risk regulation in a vacuum but, rather, consider the regulatory framework as a whole. So I would ask if you agree with this sentiment: Should Congress be looking at the broader structure that has been in place for 75 years when it debates systemic risk in looking at a way to give—well, anyway, let me ask your response, Mr. Wallison.

Mr. WALLISON. Yes, I absolutely agree with that, Congressman Royce. I think it is exceedingly important that we understand what is happening in the financial services industry as a whole. Those companies, all the different industries, are competing among themselves. It makes no sense anymore to try to regulate them in separate silos. So the Treasury Blueprint was a very sensible way, I think, for Congress to begin to look at how the financial services industry would be regulated. And I certainly agree with everything you said.

Mr. ROYCE. Thank you. I yield back.

The CHAIRMAN. The gentlewoman from California is now recognized for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman. I would like to thank all of our witnesses who have appeared here today. I am particularly pleased about the testimony of Ms. Terry Jorde, president and chief executive officer of CountryBank U.S.A., on behalf of the Independent Community Bankers of America.

Let me just say, Ms. Jorde, that I heard your testimony about your bank. The only thing wrong with your bank is it sounds too much like Countrywide, and you ought to be worried about that because, despite all of the testimony about Fannie and Freddie, it was Countrywide who threatened Fannie, that if they didn't take their products, that they would just kind of squeeze them out of the market. And of course, Countrywide was a nonbank that was unregulated by anybody.

I am from California. I think we have at least repaired part of the problem where we require the licensing of all these brokers. Countrywide had only had one license, and it had anybody who could breathe to go out and initiate loans. And there is a lot of fraud that was involved in that, and I appreciate the testimony of all of those who understand that it is not simply a systemic regulator, someone who I think, as was indicated, sitting on the top of all of this that is going to make it work.

We really do need consumer protection, and if we think we are going to get it from the same people who have been in the system, I don't think so, not because they are evil people, they just don't think that way.

All of our regulators think about how to notice the banks, how to warn the banks, how to talk with the banks but they never talk about how to stop them because of the way that they think they absolutely believe that you should let the marketplace work. All of those exotic products that were placed on the market, whether they were, Alt-A loans or adjustable rate, option loans, etc., as long as these kinds of products can be put on the market without any scrutiny, without any real interference by regulators, we are going to have a problem.

The mailboxes of citizens are being swamped now with new products because of the foreclosure meltdown. Now, the insurance companies, many of them I guess owned by maybe some of these banks, I don't know, are flooding the mailboxes with mortgage protection. What is it? How does it work? I don't think the regulators have been here to talk about it. And out of this crisis that we have, now we have all of the loan modification companies that have sprang up, and all they need is $3,500 to start to work to help someone get a loan modification. No regulator has said a word about this.

And so we sit here and, of course, we think that they know what they are doing, but I am afraid that if we have a systemic regulator they are going to come from Goldman Sachs; and it seems to me Goldman Sachs is everywhere. Not only was it our past Treasurer, it is our now present Treasurer.

I understand that Edward Liddy over at AIG worked for Goldman Sachs, and we find that Goldman Sachs was kind of taken care of when they were brought in to snatch up Bear Stearns for pennies on the dollar. And then we find that now Goldman Sachs is taken care of, again, through AIG; and of course we took care of them in our TARP program with the capital purchase program, and I guess they are sitting on top of all of this.

Am I to expect that this systemic regulator who will probably come out of the same market that caused this problem is going to cure all of this? We need a consumer protection agency to deal with all of this. Don't forget, it was the activists and the consumers who went before every bank merger attempt and went to the hearings held by the Fed and everybody else, saying, "Don't do that." And they talked about the problems that would be caused.

Now, I want to ask again the idea of the consumer protection agency that came from Labor, to please explain what you are.

The CHAIRMAN. We will have time for a brief answer.

Mr. SILVERS. The Congressional Oversight Panel recommended a consolidation of consumer protection and financial services, by which we meant financial services like mortgages, credit cards, commercial bank deposits, perhaps insurance; that those functions should not be with the same institutions charged with safety and soundness, because there is an inherent tension. And, Congresswoman, as you put it, the safety and soundness arguments always win out over the consumer protection arguments in those institutions.

So we recommended in our report, the AFL–CIO supports that recommendation strongly. We see that function as distinct from the kind of work that is done with investments that are at risk by the SEC. We see those as two separate important functions. And by the

way, with respect to the Paulson Blueprint, though I have great respect for the former Secretary, that Blueprint clearly envisioned dismantling investor protection. It clearly envisioned, in the guise of reregulation, actually weakening regulation of our financial markets, and in that respect would be a terrible thing to follow.

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Just to set the record straight, if I heard my colleague, the gentlelady from California correctly, speaking that Countrywide was not regulated, that will come as news to both the OCC and the OTS who at different times during Countrywide's existence regulated those institutions.

Mr. Wallison, you have a lot of your written testimony that you were unable to speak about in your oral testimony. I thank you for being here. I thank you for your very thoughtful op-ed in the Wall Street Journal today. Certainly you bring a wealth of credibility to this panel as being one to have the clarity and call that Fannie and Freddie were presenting a huge amount of systemic risk to our economy.

In your testimony, you say that the design of a systemic regulator could cause more Fannie and Freddies to take place in the future. Although I don't remember the exact quote, our President, in his State of the Union address, said something along the lines of before we can correct our economy going forward, we have to understand how we got into this situation in the first place. That is a paraphrase.

Can you speak exactly how significant was the role of creating a federally sanctioned duopoly in Fannie and Freddie, giving them affordable housing goals that ultimately brought down their lending standards? What role do you believe that played in the economic debacle we see today?

Mr. WALLISON. I think that structure is largely responsible for the financial crisis that this country is experiencing. And that is because Fannie and Freddie essentially were a distortion of the credit system.

Congress had a good idea, it seems to me, in intending to support homeownership in the United States. There are a lot of benefits that come from homeownership and it is a good idea to support it. But Congress chose to support it through Fannie and Freddie and CRA by distorting the credit system and asking private organizations—private profit-making organizations—to bear the cost and hide the cost in their balance sheets and in their income statements.

And so we never really understood the risks that they were required to take in order to support this congressional objective. If Congress wants to accomplish something, it should accomplish it by appropriating funds so the taxpayers can understand what the objectives of this government are and what it is spending on those things, and not push all of those costs on to private sector balance sheets and income statements.

Mr. HENSARLING. So in many respects, in retrospect, the market viewed Fannie and Freddie as systemically significant inasmuch as they had an implicit government guarantee which we all know now is explicit?

Mr. WALLISON. Yes.

Mr. HENSARLING. Can you elaborate on your fear of having a systemic regulator designate other firms as—I will try to say that—as systemically significant, and how that might further exacerbate future Fannies and Freddies?

Mr. WALLISON. It offers the opportunity to create an unlimited number of future Fannies and Freddies. The essence of Fannie Mae and Freddie Mac, the reason they became so powerful, so large, and ultimately were able to take so much in the way of risk, is that they were seen by the markets as backed by the government. And no matter what the government said about whether it was backing them, the markets were quite clear about this: The government was going to back them if they failed.

Now, that is the kind of situation that we are creating when we are talking about systemically significant companies, because if we create such companies, if we have a regulator that is blessing them as systemically significant, we are saying they are too big to fail. If they fail, there will be some terrible systemic result. And therefore, the market will look at that and say, well, we are going to be taking much less risk if we lend to company "A" that is systemically significant rather than lending to company "B" that is not.

Mr. HENSARLING. Mr. Wallison, you may have to have a very short answer to this question, as I see the yellow light is on, but the risk of making the Federal Reserve the systemic regulator, can you elaborate upon your thoughts?

Mr. WALLISON. Well, the problem with that is it just adds credibility to what I just said: the market will believe that systemically significant companies are backed by the government. But if they are regulated by the Fed, the Fed has the money available already, without congressional by-your-leave, without any kind of further authority, to cover up any problems that occur in the regulation of these systemically significant companies by providing the funds under its existing authority to deal with special exigent circumstances of various kinds.

So making the Fed the regulator would be the one thing that would cap the whole question of whether we are creating companies that are backed by the Federal Government. You would make it perfectly clear, without doubt.

Mr. HENSARLING. Thank you.

The CHAIRMAN. The gentlewoman from New York.

Mrs. MCCARTHY. Thank you, Mr. Chairman. Since we are discussing a systemic risk regulator, it would be appropriate to see how systemic risk is being evaluated now by our government. And most recently, or very much in front of us today, is AIG which was saved because it was a systemic risk to the American economy. Yet when we saw the counterparties that were released this week because of the constant requests from this committee, we find out that a significant amount, billions and billions, tens of billions of dollars, went to foreign banks.

Now I would like to ask the panelists, do you feel that bailing out foreign banks is important to systemic risk of the financial institutions of our country? I would think that bailing out foreign banks would be important to the governments of their country, but why is our government bailing out foreign banks?

And the reason I ask this is when we are talking in a general sense about systemic risk, we have an example before us in concrete terms of how it is being interpreted by our own government. I do not believe we should be bailing out foreign banks. I believe other governments should bail out their own banks.

I would like to ask the panelists, do you feel that that is a proper use of taxpayers' money, under the guidelines that it protects the systemic risk of the financial institutions of America? Do you believe we should be bailing out foreign banks? Are they a systemic risk to the American economy?

Mr. WALLISON. Let me try to start on that, Congresswoman, and just say that if you were to bail out any U.S. bank of any size, you are going to be bailing out foreign banks, because banks are all interconnected. They make loans to one another. And that is, in fact, the essence of the financial system; banks and others are all intermediaries; they are moving money from one place to another.

Mrs. MCCARTHY. So are you saying we should be bailing out all foreign banks because they are interconnected with our banks?

Mr. WALLISON. I am saying the opposite. I am saying that if we were to create a systemic regulator—a systemic risk regulator that has the power to bail out U.S. banks, you would in effect always be bailing out foreign banks, because all banks, especially at the international level, are interconnected.

Mrs. MCCARTHY. My question was not American banks, such as Citibank and JPMorgan Chase that are international banks. Obviously we have a huge stake in saving these financial institutions.

My question is, should we be bailing out the Bank of Germany, which is owned by the German Government, or a French-owned bank, in their countries? So personally I don't feel that is systemic risk to the American financial system. Maybe we could go down the line and people could give their opinions. To me, I don't believe that, in my opinion, bailing out a French or a German bank poses systemic risk to the financial security, safety, and soundness of financial institutions.

If anyone else would like to speak, Mr. Silvers, Mr. Plunkett, Mr. Ryan, Mr. Yingling, I would like to hear your opinion, too.

Mr. SILVERS. I think your question raises a somewhat broader question, which is what do we mean when we say "saving?" If we mean by "saving" that we are going to make good on every obligation of a financial institution with taxpayer dollars and keep the stock of that institution alive, when left to its own devices it might have to file Chapter 11; if that is what we mean, we are always in every case talking about enormous expense and, frankly a transfer of wealth from the public at large to what are essentially wealthier parties within our society.

Historically, and I think this goes to the comments of the panelists here, historically we have had a resolution process for financial institutions that where we were worried that there would be systemic or larger societal consequences if they did not make good on obligations. So we insured deposits and we have a resolution process for insured depository institutions. We have the same thing at the State level for insurance companies.

When we move, as we did last fall, into a world in which we guarantee everything—and at AIG, we actually didn't guarantee

everything. AIG is not the most extreme example of this. AIG, we just guaranteed all the fixed obligations. But when we move into a world where we guarantee everything, we inevitably end up guaranteeing institutions, such as perhaps foreign banks, but perhaps we might not be comfortable doing so if we had more of a resolution process.

Perhaps on a resolution process, it would be possible to sit down with foreign governments who obviously have a stake in the same matter and work that out. But when you begin with the assumption that "rescuing" a financial institution means that everyone gets made good at taxpayer expense, then you have a problem.

The CHAIRMAN. The gentleman from New Jersey.

Mr. GARRETT. Thank you, Mr. Chairman.

And I think that the bankers who sit on this panel are probably astonished and shocked at the opening of today's hearing when you heard from the other side of the aisle—what did they say—we don't regulate anything in this country anymore. You were probably wondering, who are those guys with green eye shades who call themselves examiners, who come into your banks every so often? Who are they if we are not regulating anything? But I digress.

Mr. Silvers, on the line of deregulation and what have you, you did make a comment to one of the questions that we have deregulated, and in the last dozen or so years there has been a taking back of so many powers.

Just very briefly, aside from Gramm-Leach-Bliley, which we know some people say is deregulation—other people argue it allowed for the diversification which is helping these big banks out there to stay afoot—can you just run down four or five of the major acts of Congress we passed in the last dozen years that you are referring to where we deregulated the financial situation in this country?

Mr. SILVERS. Well, you certainly mentioned one which is Gramm-Leach-Bliley. The second was the Commodities Act—and I can't recall the formal title—which deprived the CFDC of the ability to regulate financial futures—financial derivatives and other derivatives. A third was not Congress, at least Congress didn't act formally. It was the court decision that took away from the SEC the ability to regulate hedge funds. Congress then failed to act in response to that.

Fourth was—here is an instance where Congress acted responsibly but the regulators didn't act, where Congress gave the Fed the ability to regulate mortgages comprehensively, and the Fed didn't use it.

The fifth is somewhat older, which is—and I think goes to the—

Mr. GARRETT. Both of these are not taking away. This is not congressional action. And the action on the hedge funds, which I think was number three, hedge funds really aren't in as much problems as all the other areas in the banking sector which have been continuously regulated.

Mr. SILVERS. I don't see it that way.

Mr. GARRETT. The losses are certainly less.

Mr. SILVERS. They are less because the taxpayers have propped them up. A key issue in Bear Stearns, for example, was the interweaving of Bear Stearns' business with some large amount of

hedge fund money. No one really knew for sure how much because it wasn't regulated. My point about deregulation is the responsibility doesn't rest solely with Congress in this matter. The courts have contributed, the failure of agencies to act when they have been given powers have contributed.

Mr. GARRETT. Okay. And I appreciate that. And it is on that last point on not acting is maybe where I will make my main point.

Mr. Plunkett, I will just say on your point I was with you on most of what you were saying. And you are saying that we can do a lot of this, what we need to do, with the existing regulations and sharing the information. And I think I was following you, and I agree with you on a lot of those points. You lost me when you talked about solving it by regulating salaries or executive compensation. Up to that point, I was right with you. But I appreciate a lot of your testimony.

Ms. Jorde, a quick question. The suggestion that was made here with regard to requiring the banks to hold a portion of it on their books on securitization. Wouldn't that be actually problematic for some of your smaller banks who right now have to sell it all and that is how they are able to lend? Just very briefly, could that cause a little bit of a problem for some of the small banks?

Ms. JORDE. And that was my point initially, is that to hold a part of it, then you are in effect servicing it.

Mr. GARRETT. Not even the servicing it. As the chairman said, you might be able to get rid of that somehow. But even just the fact you have to hold it, your ability to loan might be constrained somewhat.

Ms. JORDE. Well, certainly the more that you can sell off, it leaves your capital available for lending. But for the most part we are portfolio lenders. It is whether or not you can give the advantage to the borrower as far as 30-year fixed rate mortgages, how you price those things, so that a community bank doesn't end up with asset liability issues. I think those are the things that would need to be worked out.

Mr. GARRETT. I really appreciate that. And finally, Mr. Yingling, you always have to be careful when you bring in an analogy like that, because somebody is going to jump on it, about Mount Olympus. Who was on Mount Olympus was Zeus, And I came up with the acronym of "zero errors under supervision" that this person would have to be providing us with, that there be no errors anymore.

But the problem is we have all these regulators and they haven't been able to provide us with that lack of errors. As a matter of fact, in the Wall Street Journal we have this comment from Scott Polakoff, who is the Acting Director of the Office of Thrift Supervision, and he said it is a myth about AIG, about them not being regulated, that regulation was regulated by a collage of global bureaucrats and the Financial Products Division did not slip through the regulatory cracks. He goes on to say that the agency should have taken an entirely different approach in regulating the contracts written by their product.

So, this goes back to Mr. Silvers' comments, we have the regulators there, they were sitting up on high, they were working with the global folks, as Mr. Silvers also suggested that we need to do

on a global perspective, but still they couldn't see it, and it is only in retrospect that they were able to look back now and say, ah, this is what we should have done.

And I guess, Mr. Wallison, isn't that the ultimate problem that we are going to get to, that even if you have all this in place, the regulators will always be saying after the fact that is what we should have done?

The CHAIRMAN. Mr. Wallison, very quickly. We are over time. So if you want to respond, it has to be very quick.

Mr. WALLISON. I will say yes, that is exactly correct.

Mr. GARRETT. He said it was exactly correct, I think.

The CHAIRMAN. Yes, but your microphone is off.

Mr. WALLISON. We keep thinking that we have solved the problem, like with FDICIA. It is never going to happen again. But in fact, regulation is not an effective way of preventing risk-taking.

The CHAIRMAN. Thank you. The gentlewoman from California asks unanimous consent to speak for 1 minute.

Ms. WATERS. Thank you very much, Mr. Chairman. I asked for time so that I could make a correction and a clarification, that Bear Stearns was actually purchased by JPMorgan, and on Countrywide, yes, they were formally regulated but they didn't do a very good job of it.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman. If there is one thing I am learning pretty quickly about this whole subject area is this kind of discussion is important and don't necessarily buy in to the first reaction that you usually have on these issues.

Two examples I can give you right quick. I am not so sure that I am ready to jump onto the retention of risk, the skin in the game philosophy. Although it sounded very intriguing initially, it seems to me at some level there is a tradeoff between regulating so that people stay out of these risks and incentivizing people to stay out of it by requiring that they have skin in the game. And I would hate to think that we would get to the point where we cease to look at the regulatory side using as an excuse that you have a market incentive because we are requiring you to keep skin in the game. It also seems to me as you go on down the line if you are going to require the original lender to have skin in the game, you have to have the first securitizers and the second securitizers, and the impact of that would be to in some fashion reduce the amount of credit that is out there in the market.

So I am not going to ask you to comment on that because I want to go to the second reaction that I initially got to, is that it might be a good idea to have the Fed be the systemic regulator, and I am beginning to have second thoughts about that, too. I don't know how you have a systemic regulator who also has day-to-day regulatory authority without shielding that regulatory authority in some way or compromising it. I don't know how you have a systemic regulator who does monetary policy without shielding monetary policy, insulating it from the systemic regulation function. I don't know how you have a systemic regulator and have that regulator have responsibility for consumer protection without insulating it. And if you are going to insulate it to the extent that it seems to me it needs to be insulated, you basically have taken some de-

partment or part of the Fed if it is all inside the Fed and created a separate entity anyway. And I am not sure that it wouldn't make more sense to actually go ahead and create a separate entity.

Mr. Bartlett and Mr. Wallison, react to my concerns about the prospect that putting systemic regulation on the Fed would compromise in some way monetary policy responsibilities of the Fed and consumer protection responsibilities of the Fed.

Mr. BARTLETT. Thank you, Congressman. And like you, our thinking has evolved on this over the course of 3 years, and specifically in the last 6 months. First, we do not propose to create additional day-to-day regulatory authority by the Fed. In fact, we would move—

Mr. WATT. So you take some of the regulatory, day-to-day regulatory authority from the Fed and give it to somebody else?

Mr. BARTLETT. That is right. We would not create additional regulatory authority. We would take some of it. And then second is that we would give—

Mr. WATT. But you can't take the monetary policy from the Fed?

Mr. BARTLETT. That was the second point. We see monetary policy and systemic regulation as quite consistent because they are both engaged in trying to provide for an orderly economy, economic issues, and so they have very consistent goals. We don't see that as inconsistent at all.

Third, I take the point that we specifically reject the idea that there should be created a list of systemic companies or a list of firms or we reject a size criteria. We think 6 months ago we were in those same conversations, but I have to tell you after the same considerations with some of the same comments made by Mr. Wallison and others, the idea of creating a list of companies that are systemic is the wrong approach. Instead it should be those activities and practices that cross over lines that affect the entire financial sector.

And then last is we think that if you give the power to regulators who have the safety and soundness power and then you give them the power and the authority and the mandate to act for consumer protection, you can profoundly provide a great deal more consumer protection than we are getting with a separate agency.

The CHAIRMAN. Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. I think one of the things that I want to follow up on, I think some of my colleagues have made this point and I think it is in a more simplistic point of view, is you can talk about crime. And you have a crime problem in your city, and so the first inclination is we need to add more police officers. And many cities have tried that model. They added more police officers. But the bottom line is maybe crime statistics went down but you still had crime. While other cities have implored a system where they change the patrol patterns and other activities and basically got the same results.

And Mr. Wallison, I tend to agree with you. I think what we have to be careful here is did we just have an oversight problem in some respects at the regulatory area, but we also just had quite honestly a corporate governance problem. We had people taking risk that there didn't seem to be consequences for. And now what I am afraid of is that we are almost creating more systemic risk

in the patterns and activities that we are doing right now by showing that the government will step up and take away the consequences if the bill gets too big.

And so I think I share the same concerns that once you—in fact I told Secretary Paulson this on a telephone conversation last fall. I said, Secretary Paulson, I don't want to be a Triple A credit, I just want to be on your systemic risk list. Because what that allowed me to do is not to have to behave in any particular way because the marketplace knew right away if I was on the big boys list that I was going to be okay and it was all right to do business with me.

I don't want to recreate that scenario in this country where people say, you know, our whole business model here is we are trying to get on the systemic risk list. It needs to be a punitive list, if anything.

But the question I have to the panel is, isn't a part of the safety and soundness analysis that the current regulatory structure should be looking at as these entities get extremely large and get into extremely complex types of investment activities, shouldn't that in fact trigger some additional capital requirements or leverage requirements that in fact begin to manage that company in a way that we don't let it get to "systemic risk."

And I will start off with you, Steve.

Mr. BARTLETT. A quick answer is, yes, it should. And we think that a systemic regulator then in working with and through the powers of a primary supervisor could accomplish exactly that.

If I could take 30 seconds on crime, because when I was mayor of Dallas we faced something similar, and it is a great analogy. The City of Dallas had had an increase in the numbers of violent crimes every single month for 20 years, hadn't missed one. And it tried everything they thought; incarceration. But it was more police on the beat and such as that. And then we tried systemic prevention. We identified the locations, times of day, times of week, and individuals who were engaged in crime and went out and talked with them and had a 42 percent reduction of violent crime within 2 years. So a systemic approach to these problems can work. It worked in that case, to use your example, Congressman.

Mr. NEUGEBAUER. Mr. Ryan.

Mr. RYAN. As I have said before this committee before, we are in favor of a systemic risk regulator so that we have someone who has the capacity to look over the horizon. Right now regulators are restricted either by charter or geography. We need a regulator that has all of the information so that they can look at all of these interconnected entities, notwithstanding their charter, what activities or products. That does not exist today.

Mr. NEUGEBAUER. Mr. Wallison.

Mr. WALLISON. I think there is no reason why we couldn't have some organization that looked over the entire economy and looked for questions like systemic difficulties. The question would be whether there is then any authority in that body to actually regulate, and that I think would raise some very serious questions. I think we ought to keep our eye on the ball in one respect, and that is that regulation is not a panacea. It does not cure problems. We have to regulate all those companies that are backed by the govern-

ment. But when you are not backed by the government, you should be allowed to fail. It is one of the most important things we have in our economy that makes sure that the bad managements go out of business, the bad business models go out of business, and they are replaced by better managements and better business models.

Mr. NEUGEBAUER. Failure may be the best regulator that there is?

Mr. WALLISON. Exactly.

The CHAIRMAN. The gentleman from California.

Mr. SHERMAN. Thank you, Mr. Chairman.

Mr. Bartlett, you have suggested in your opening statement principle-based standards, which tends to mean that we just have vague standards that say do the right thing, don't take unnecessary risks, treat people fairly. And we rely on the conscience of the individuals to interpret those terms and apply them. Do you think that we can get away from explicit standards and rely on loudly proclaimed broad principles. And do you think that those who have been attracted to the financial services industry and Wall Street have evidenced recently a willingness to just do the right thing and act in the national interest?

Mr. BARTLETT. Well, Congressman, I will review my testimony to make sure I didn't say it that way. I didn't call for vague standards. I called for principle-based regulation. So you establish the principles. Our first principle is treat your customers fairly. But then the regulations themselves are promulgated consistent with those principles. So you would still have regulation.

Mr. SHERMAN. All regulations should reflect the values and principles of the country. So you are not suggesting that we shouldn't also have numerical standards, detailed regulations, etc.?

Mr. BARTLETT. I am suggesting that all regulations should reflect uniform standards, but they don't because the Congress has not established uniform standards or uniform principles. I think that the principles should come from consideration by Congress and then the regulation should be developed to enforce those principles.

Mr. SHERMAN. Okay. Let us move on to Mr. Silvers.

Do you think that it makes sense to have the Fed simultaneously be the regulator who occasionally will make mistakes. And I know the chairman has pointed out that regulators try not to admit mistakes, none of us do, and also be the agency that can spend billions and trillions of dollars to rescue firms and in effect sweep the mistakes under the rug, delay the explosion, and maybe hope for the best.

Mr. SILVERS. I think that we should have learned a lesson from the last year, which is that there are times and circumstances in which no matter whom is in political power that certain institutions to some degree, whether that is in a form of a restructuring or a conservancy or in the form of a flat out rescue of the kind that we have been offering recently, that some institutions are going to be rescued in certain circumstances. And that given that is the case, that Republicans and Democrats, conservatives and liberals, seem to do it, that given that that is the case, that we ought to have clear criteria for when to do it, that the people who make the decisions ought to be clearly publicly accountable and that these things ought to be set up in advance and not ad hoc.

Mr. SHERMAN. I couldn't agree with you more on those things. Shouldn't we have the same entity be the regulator and the "bailer outer?"

Mr. SILVERS. And so consequently the Fed as it is currently structured does not meet those tests. Now, if it was structured to be a fully public agency, would it still be appropriate for it to be the regulator and the bailer outer? And my view, although I don't think there is a perfect answer to this, is that there are some reasons to have the people who have to foot the bills have to think about what structures you want to have in place beforehand to ensure they don't have to pay. In doing so one runs the risk, and I think, Congressman, you have pointed that out very clearly, that particularly if you have government structures that are essentially self-regulatory you run the risk of essentially a partnership developing between the failed institutions and the regulator to keep those institutions—to fully ensure and pay off everyone involved in those institutions at taxpayer expense and to ignore the fundamental lesson I think of the last year, which is that while some institutions may be systemically significant, not all layers of the capital structure of those institutions are.

Mr. SHERMAN. Thank you. I am going to try to squeeze in one more question for Mr. Bartlett.

A number of us are working on tax legislation designed to impose a surtax on excess executive compensation of those who bailed-out firms. Now, putting aside how we would define excess compensation, can you see a reason why we should allow executives to retain without paying any particular surtax compensation that you and I would agree is excessive.

Mr. WATT. [presiding] I am afraid the gentleman's time has expired. Go ahead and answer the question briefly, quickly, if you can.

Mr. BARTLETT. No.

Mr. WATT. I think that is a pretty quick answer.

Mr. SHERMAN. I will take that as a maybe.

Mr. WATT. If you want to follow-up, you can do so in writing. Mr. Castle is recognized.

Mr. CASTLE. Thank you, Mr. Chairman. I will throw up two questions, and then I will just duck and let you try to deal with them. And I think Mr. Bartlett touched on this a little bit in his opening statement, maybe not too definitively. But it is a little bit off systemic risk regulation, but bank regulation in general. We have many entities, both at the Federal level and you have State entities too, who regulate different financial institutions in this country, depending on what they do. And my question is, do you believe that there should be some consolidation in that area? Should there be more of a reaching out in terms of some of the leverage type of circumstances that exist today in hedge funds, etc., in terms of what we are regulating, or are we okay in terms of our basic regulation?

So that is one question I have. The other question is more pertinent perhaps to the hearing today. And that is the Federal Reserve in general. I mean, whenever we talk about systemic risk regulation, which I basically believe in, we talk about the Federal Reserve. But I worry about the Federal Reserve in that they have responsibilities in terms of some regulation now and they have other

responsibilities that relate to our economy in a great way. First of all, if you have wild objections to the Federal Reserve, I would like to hear that. And secondly, if you feel the Federal Reserve perhaps should give up certain powers if they were to take on a systemic risk regulation component, I would like to hear about that as well.

So those are my two areas of concern. I open the floor to whomever is willing to step forward.

Mr. BARTLETT. Congressman, let me take them one at a time. We do think that there should be some basic reformulation and convergence, that there should be a prudential supervisor that should supervise banks, insurance, and securities at the national level with uniform national standard. It should follow the "quack like a duck" theory. If it quacks like a duck, walks like a duck, and talks like a duck, then it is a duck, and should be regulated like a duck, the same with banks, insurance companies, or securities. And today we have a hodgepodge of chaotic hundreds of agencies that regulate the same kinds of activities in widely different ways.

We found, and there is nothing perfect, we think that the Fed is the best equipped to be a systemic regulator, as we have described it, which is no list of—not a list of specific firms, but rather the systemic oversight. We think that is very consistent with their monetary policy, which is the strengthening and the stability of the economy. We do recommend that the regulation of State chartered banks be moved over to the bank regulator. And we have struggled with this. We do think that the bank holding company regulation should stay at the Fed. Probably the main reason for that is just they do it very well and we don't see a reason to change it.

And then last is the Federal Reserve has the breadth and the scope and the institutional knowledge of almost a century of understanding both the economy and the financial markets, and we don't think that that can be duplicated or replicated in the space of half a dozen years perhaps. So we think we should use that to the government's advantage.

Mr. CASTLE. Mr. Yingling.

Mr. YINGLING. Mr. Castle, I think as I listen to this panel and a lot of the concerns of the members, we have to define what systemic regulation means. And I think a lot of us are talking not about detailed in-depth regulation, we are talking about looking out and seeing where the problems are and then using the regulatory system as it exists to solve those problems and then supplementing the regulatory system where we have gaps. So that we would not get into all the problems of having some super, super regulator out there. That is not what we are talking about.

Again, I think it is critical to look at that resolution process because that is going work backward and affect who is considered too big to fail. And I think I have heard everybody here say we shouldn't have a list that identifies people as too big to fail.

One thing I do think the Fed could give up is the holding company regulation of small banks. It really makes no sense to have the Fed regulate the holding company of a $100 million bank that is regulated by the FDIC, the State, or even the Comptroller. A lot of times they go in and that holding company is nothing more than a shell. So as they get the new authority I think they can give up the holding company authority over smaller institutions.

Mr. CASTLE. Thank you.

Yes, sir, Mr. Wallison.

Mr. WALLISON. Just two points that you made handled very quickly. The Fed would be a very poor choice as a systemic regulator if the purpose of systemic regulation is to identify and regulate individual companies. I think I hear that most people here do not favor that. But should that happen the Fed would be very bad from that perspective because it compounds the problem of making it look as though those companies have been chosen by the government not to fail and it has the financial resources that can actually bail them out.

So depending on what the systemic regulator is chosen to do, the Fed could be a very bad regulator.

The second point you have asked is do we have the right amount of regulation now, should we extend regulation beyond the banking industry. And my view is no. That regulation is appropriate and in fact necessary, essential, when companies are backed by the government because then there is no market discipline, there is moral hazard, etc. Where they are not backed by the government regulation tends to add moral hazard. And so what we ought to do is leave these companies alone and let them fail, because that is exactly the way we preserve good managements and we finance good managements and good business models, because they survive the tough periods.

Mr. CASTLE. Thank you. I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman from New York, Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman.

And I want to thank all of you for testifying today. I think that your testimony lends to the fact that we really need to think this thing through. It has been very thought-provoking for me.

And I think that everyone will probably agree to, at least, surely the way I look at it, that our regulatory system did work. We now have a problem because we have a new train running on old tracks. And so it worked for a period of time until now, and then that train ran off the track.

And what we are talking about now, when we are talking about a systemic risk regulator or however we are doing it, to create new tracks for the train. I don't want to get rid of the train, because capitalism ultimately evolves, and I think that we are evolving. But we need some type of regulation to make sure that the train doesn't go off the track, which then causes damage to society in general.

And so we have to figure out who do we need and what do we need. Whether it is someone in the Fed or whether it is an entirely new regulator, a systemic risk regulator, combining others. You know, I don't know. That is why I find some of your testimony intriguing, and I want to consider to listen and learn and move forward.

But, also, I think that—and I think that Mr. Silvers spoke on this a little bit, and of course Mr. Bartlett also—we are in this new world that we currently live in. It is global; it is indeed global. And the question that comes to my mind is, are there areas—unless we can fix our own system, you know, create these tracks for our own

train, will we be running right off the track again if we don't have some kind of a global regulator?

Because I keep hearing consistently how everything is now intertwined, they are all running into one another at some point. You are selling one thing to another bank. My colleague, Carolyn Maloney, was talking about banks across the ocean. And one of the answers was, well, when you help an American bank, you are helping a foreign bank, because they are all interrelated.

Well, if that be the case, then isn't there an urgent need for also talking either simultaneously or trying to figure out what a global regulator would be? Do you think that we need to have one?

I guess I will direct that question initially to Mr. Silvers and then to Mr. Bartlett and then to Mr. Ryan.

Mr. SILVERS. Congressman, I think it is a very good point. You know, Angela Merkel, the Chancellor of Germany, came to Hank Paulson in 2007 and suggested that perhaps we ought to have more regulation of hedge funds. The Bush Administration didn't like that idea and thought that we didn't need more transparency. And then they found themselves in the middle of the night thinking about what to do about Bear Stearns without the very transparency that they could have had when Angela Merkel brought it to them.

We are now back facing the G20 meeting coming up where, once again, the proposition is going to be put on the table by Europeans, of all people, that we ought to be more serious about transparency and regulation of shadow markets on a routine basis. And we have the opportunity not to be the drag on that process but to lead.

It is not necessary to lead to have a global regulator. A global regulator is a thing that may be far in the future, but it is necessary and quite possible to have coordinated action. And if we don't have coordinated action, poor practices in other countries may leak into our markets, and we may be perceived as being the source of poor practices elsewhere, as we were, say, in Norway when our subprime loans blew up their municipal finance.

That challenge is right in front of us, and we can lead. And it ought to be a priority of the Administration, and I am hopeful it will be, to do just that.

Mr. MEEKS. Thank you.

Mr. Bartlett, quickly. I want to have Mr. Bartlett, then Mr. Ryan.

Mr. BARTLETT. Quickly, and then I think that Mr. Ryan might have something.

I think that we shouldn't have one global regulator, but we should harmonize our systems, for our benefit as well as the world's. And, specifically, we should harmonize the accounting systems of IFRS and GAAP accounting. We have found that to be an increasingly problematic area.

Mr. MEEKS. Mr. Ryan?

Mr. RYAN. Yes, sir. Clearly, we have global financial institutions, we have global capital markets. We have been talking about securitization. We spent an awful lot of time in Brussels and around Europe, talking with regulators. This whole issue of retention is actually far afield, far ahead in Brussels. That market is totally globalized.

So we have already seen the effects of global regulation and impact on some of our markets. And, clearly, we are going to have to be in sync on a global basis. Whether that means one regulator, we have not really faced that issue yet. We are more concentrated on what happens here right now.

The CHAIRMAN. The gentleman from Georgia.

Mr. PRICE. Thank you, Mr. Chairman.

I want to thank the panelists, as well, for their testimony today and their forbearance with the questions and the time.

I think it is important to remember that our Nation has provided the greatest amount of freedom and opportunity and success for more people than any nation in the history of mankind. And I think it is incumbent upon us to appreciate that we haven't done that by virtue of excessive regulation. It would seem that it would be important for us, as Members of Congress, to attempt to define what has allowed that success—if you define that as success—what has allowed that success to occur and attempt to embrace those fundamental principles.

Everybody has talked about systemic risk, but I don't know that we have a definition of it. Anybody care to give me a definition of systemic risk?

Mr. BARTLETT. Dr. Price, I would share the one that we have come up with, and this is about our 18th draft:

"Systemic risk is an activity or a practice that crosses financial markets or financial services firms and which, if left unaddressed, would have a significant material and adverse effect on financial services firms, markets, or the U.S. economy."

Mr. PRICE. So somebody has to decide what has a significant adverse effect on—the rest of that sentence.

Mr. BARTLETT. Yes.

Mr. PRICE. That, you would suggest, ought to be the systemic regulator.

Mr. BARTLETT. Yes, or market stability regulator, yes.

Mr. PRICE. So somebody in the wonderful buildings around here will determine whether or not a financial institution ought to have explicit support of the Federal Government. Is that what you are saying?

Mr. BARTLETT. No, Congressman. We are not calling for explicit or implicit support of the Federal Government. We are not calling for identification—

Mr. PRICE. Excuse me, I only get 5 minutes. Tell me how that isn't a consequence of that definition.

Mr. BARTLETT. Because the outcome of identifying systemic risk is to go to the prudential supervisor and then supervise that firm in a different and a better way. That is the outcome. It is not to provide the implied bailout or the support.

Mr. PRICE. Anybody disagree with that being the outcome?

So we all agree that systemic risk institutions no longer get explicit government support. Is that correct?

Mr. BARTLETT. Congressman, I guess what I am trying to say is that we don't see the outcome of this as identifying systemically significant institutions. We see it as identifying systemic risk across those institutions so that a poorly underwritten mortgage is

not simply sold up to someone elsewhere where it is still a bad mortgage.

Mr. PRICE. No, I understand that. But at some point there has to be a consequence for the decisionmakers here. We have determined, somebody has determined that there is an entity that is a systemic risk. So what ought to occur to that entity? It has to be something.

Mr. PLUNKETT. If you keep the entity from becoming a systemic risk through the kind of regulation Mr. Bartlett is talking about, then you don't have to face that problem. That is the prevention strategy.

Ms. JORDE. Well, and I think you are exactly on track. We first have to design what systemic risk is. We have to figure out—

Mr. PRICE. What is your definition?

Ms. JORDE. What is my definition? Well, one is that the CEO doesn't know what the right hand and the left hand is doing. If the organization is so large that the very people at the top and the board of directors has no control over the organization—

Mr. PRICE. So you believe it is appropriate for the government to determine whether or not a CEO knows whether the right and left hand know what they are doing?

Ms. JORDE. Well, I think it is important that the company is not so large that their failure will bring back everybody under the house of cards. That is what I am facing as a community banker. I am paying hundreds of thousands of dollars now for FDIC insurance premiums to cover the risks of the systemically largest institutions.

And I think that, before we figure out who is going to be the regulator, we need to identify the criteria of what this regulator is going to do—

Mr. PRICE. I would agree. And I think that is almost an impossibility. And I would suggest that community banks, independent community banks, might find themselves out in the cold; that the Federal Government may determine that all those big boys are systemically risky, systemically significant, community banks aren't, and then, therefore, how are community banks going to compete.

Mr. Wallison, I would appreciate it if you would just discuss that unequal or unlevel playing field when one defines something as systemically significant.

Mr. WALLISON. That is the thing that bothers me more than anything else, and worries me. And that is just from what I have experienced with watching Fannie Mae and Freddie Mac.

When the government chooses a winner, when the government chooses an institution that it is going to treat specially, different from any other institution, then the market looks at that and decides, quite practically, that I will be taking less risk if I make loans to such a company. And when that happens, those companies then become much tougher competitors for everybody else in the industry.

The result will be a collapse of the very competitive financial system we have today and the consolidation of that system into a few very large companies that have been chosen by the government—whether they are banks, securities firms, insurance companies, hedge funds, or anything else.

Mr. PRICE. Thank you, Mr. Chairman.

I think that is a concern that many of us share. Thank you.

The CHAIRMAN. The gentleman from Kansas.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman.

And thanks to the witnesses for testifying.

Like my constituents, I am angry at the recent news reports of AIG handing out bonuses, or what they call retention payments, totaling $165 million. And this happens after the Federal Government has committed $173 billion in taxpayers' money to support AIG.

As I understand it, these bonuses are going to employees of the same division that made hundreds of billions of dollars' worth of very risky credit default swaps that fell apart and contributed to the financial meltdown.

We also learned this week that Citi's CEO, Mr. Pandit, who testified before this committee on February 11th, made $10.82 million in 2008. When responding to my questions of how much the eight CEOs of the big banks made, Mr. Pandit told this committee that he was to receive a salary of $1 million with no bonus in 2008, but that he was going to take his salary of just $1 per year and no bonus until the company returns to profitability. Mr. Pandit neglected to tell this committee that he received a sign-on and retention award in January 2008 that was valued at the time at over $34 million.

Mr. Yingling, Mr. Ryan, and Mr. Bartlett, in the context of creating a systemic risk regulator, should that regulator review executive compensation practices and submit guidelines to ensure incentives are properly administered? What else, if anything, should this committee consider doing to address this concern? I would like to hear your thoughts on these.

Mr. BARTLETT. Not with regard to Citi, but on the broad question, one of the items that I think a systemic risk regulator or other regulator could and are looking at are short-term compensation strategies that reward short-term revenue growth, as I said in my testimony, rather than long-term value to the company. I think boards of directors but also other regulators are looking at that, and I think we will see a lot more of that.

I think that is the systemic risk, as opposed to the outrage over somebody is making more money than you think that they should. I think it is a systemic risk—there is a systemic risk question without regard to the politics.

Mr. MOORE OF KANSAS. Very good. Thank you, Mr. Bartlett.

Others? Yes, sir?

Mr. RYAN. I see executive comp as a very complicated issue right now for you, for the public, for us, specifically for directors. The real responsibility on compensation lies with the directors, who have been placed in their job by shareholders and that is their job.

Mr. MOORE OF KANSAS. Yes, sir?

Mr. YINGLING. I would recommend to you a report by a group called the Institute for International Finance, which is the large financial institutions all around the world, including the United States. And they have a chapter on executive compensation.

And the industry, I think, is committed to addressing these issues where compensation is just out of line, where the incentives

are wrong, and you need to have a longer-term perspective so that you don't have incentives that you can get a lot of money for something that blows up 2 years later.

And I think that is an issue that the industry believes needs to be addressed. And I would suspect that any regulatory agency is also going to want to have discussions with members of the industry on that topic.

Mr. MOORE OF KANSAS. Any other witnesses care to comment?

Mr. SILVERS. Congressman, this was the substantial part of my oral testimony earlier this morning.

There are two directions in which I think Congress ought to look to a solution in this area. I am not sure what the solution is to people who mislead you, but I can tell you what I think the broader policy solutions are.

Mr. MOORE OF KANSAS. Well, I will talk to you later about that.

Mr. SILVERS. First, as was indicated, there is a responsibility with boards of directors here, but one that boards don't carry out when they are dominated by the CEOs themselves. And there needs to be an effective way for long-term investors to influence who is on those boards. And that is the proxy access issue with the Securities and Exchange Commission.

Secondly, with respect specifically to systemic risk and the issues of short-termism and asymmetry, which were identified by the representatives of the industry here, these are matters which, at specific large firms and across the industry as a whole, must be a subject for which the day-to-day safety and soundness regulator is aware of and monitors and which a systemic risk regulator monitors.

I will finally say to you that there is no issue right now—and I am sure you know this as well as I—there is no issue right now which the general public, working people, or union members are more concerned about or are more outraged about. And statements that we can't somehow get the money back just don't cut it.

Mr. MOORE OF KANSAS. Thank you, sir.

Any other witness care to comment?

I thank the witnesses for their testimony.

And I yield back, Mr. Chairman.

Mr. GREEN. [presiding] Mr. Campbell is now recognized for 5 minutes.

Mr. CAMPBELL. Thank you, Mr. Chairman.

And thank you, panel.

Everyone generally is supporting the idea of systemic regulators, as we discussed. And I would like to pursue something Mr. Kanjorski talked about and Dr. Price followed up on, which is, what does this regulator do? If an entity is deemed to be systemically significant and, thereby, either too big or too interconnected to fail, what do we do?

Now, Mr. Bartlett suggested, I believe, that there should be regulation—that what the powers that this regulator should have would be regulation to keep it from getting too systemically important or too big to fail. If that is the case, then my question would be, who do you apply it to then?

If, instead, we determine that some entity is too big or too interconnected to fail and is systemically important, do we regulate it,

or do we break it up? Do we look at this as an antitrust situation—and this would address some of your concerns, Mr. Wallison—do we look at this as an antitrust situation and say that there are two types of antitrusts now: There is monopolistic antitrust, which we have had in law for decades and decades; and now there is a new type of antitrust, a situation where an entity is so big and so interconnected that it can't fail, which means that the government would have to support it, keep it from failing, which means that there is a moral hazard, some of which we are witnessing out there today.

And I would welcome comments from any of the panel on those two alternatives that I see or a third one, if you see one.

Mr. Silvers?

Mr. SILVERS. The Congressional Oversight Panel, in looking at this, took the view that we ought definitely not to name systemically significant institutions. And what we ought to do instead is to have a regulatory structure that, essentially, as you get bigger, as an institution gets bigger, it becomes more expensive to be there in our financial system, because you would have to have higher levels of capital and more expensive, essentially, deposit insurance or perhaps other forms of insurance that effectively pay into a systemic risk fund.

That approach would not be the approach of necessarily using legal action to break up firms, but it would be a potent disincentive, properly structured, for firms to grow to a level at which we then would have no choice but to rescue them, in which we would be faced with the Blazing Saddles problem, if you know what I mean.

And that, I think, is the—that notion, in which becoming more likely to be a systemically significant institution is something that is painful, is, I think, the appropriate approach.

And we ought to recognize, in this respect, that we don't really know who is systemically significant until the moment hits; that in very good times very large institutions may not be, and in very bad times rather small institutions may be.

Mr. PLUNKETT. There is a hearing this morning by a House Judiciary subcommittee on this very topic. We are testifying there. And while in extreme situations a consumer organization like mine might say, "Yes, break them up," the more effective approach is what Mr. Silvers is talking about, which is to use prudential regulation, not antitrust regulation, to keep an entity from getting too big to have to deal with that problem.

Mr. CAMPBELL. Mr. Bartlett?

Mr. BARTLETT. Congressman, I suppose I understand why the discussion keeps, sort of, trending over towards identifying specific firms, but let me try to offer some clarity. That is not the goal. It is a set of practices and activities across the markets, it is the system that we should focus on. There is no—at least we don't have a proposal to identify, "systemically significant firms." That should not be done. It should not be size-mattered. It should be related to whether their system or the practices create systemic risk.

Now, let me give you a real-life example of one that we just went through. Hundreds of thousands of mortgage brokers, not big companies but hundreds of thousands, had a practice of selling mort-

gage products not related to whether they were good mortgages or not, without the ability to repay. Thousands of lenders—42 percent were regulated banks; 58 percent were unregulated by anyone—had a practice of originating those loans, even though they were systemically a major risk, as it turned out, and then selling them to mortgage-backed securities on Wall Street, who then put them into pools, who then had them insured, that were regulated by 50 State insurance commissioners.

So the system itself was the systemic failure. It wasn't any one of those firms. And so the goal here, I think, is to create a regulatory system that can identify those patterns or practices that then can result in a systemic collapse before it happens.

Mr. CAMPBELL. Mr. Ryan and then Ms. Jorde?

Mr. GREEN. We will hear the answer, and the gentleman's time is expired.

Mr. RYAN. Just as to the role, as we see the role here, it is really early and prompt warning, prompt corrective action. The systemic regulator needs a total picture of all of the interconnected risks. As I have said, this regulator needs to be empowered with information to look over the horizon. We do not do that job well as regulators right now. And it also needs the power to be the tiebreaker, because there are differences of opinion between primary regulators, and if there is a systemic issue, we need someone to make that determination.

Just one last comment here. We were talking about failure of institutions. As Ed Yingling said, we already have a system set up for banks in this country under the FDIC. We had no such system for securities firms, we have no such system for large insurance companies, and we have no such system for other, what I would call, potentially systemically important entities. And we need to address that.

Thank you.

Mr. CAMPBELL. Mr. Chairman, can Ms. Jorde answer?

Mr. GREEN. The time has expired. I am sorry. We will have to get the response in writing. The Chair wants us to move along.

We will now recognize Mr. Scott for 5 minutes.

Mr. SCOTT. Welcome. Let me ask you a couple of questions, if I may.

If Congress ultimately chooses not to create a systemic regulator, what suggestions would each of you have for improving our current regulatory system?

Mr. BARTLETT. Congressman, the fastest and the easiest one—well, one would be for the President's working group to either obtain statutory authority, which they do not have, or exert greater executive authority to coordinate the regulation among the various regulators.

And then secondly is just to provide some type of relief on procyclical accounting principles, fair value accounting, which we think is a major contributor to the problem right now.

Mr. PLUNKETT. I would say empower prudential regulators to stop these problems before they start through better product-level regulation to prevent risk from being created, first and foremost.

Ms. JORDE. And I would add to expand regulation to cover nonbank financial firms, which really have been largely outside the

banking regulatory system, even those subsidiaries of banks that were regulated from the banking side but not the non-bank side.

Mr. SILVERS. Congressman, covering the shadow markets and giving full jurisdiction to the relevant regulators to regulate those activities, meaning to the extent that shadow markets are really credit-granting functions; the bank regulators, to the extent that they are really in the securities markets; the securities regulators. That is a critical thing to do here.

And, secondly, to create a consumer protection agency so that we put an end to giving that function to agencies that don't want to do it.

Mr. WALLISON. Congressman, if I can respond, the idea of regulating additional parts of our economy is a simple idea but one that seems totally ineffective. The problem is that we have strong regulation already in the banking area. It has failed. And why it is that, when we confront a situation like this, the first reaction that so many people have is to extend a system that has failed is beyond me. This is something—

Mr. PLUNKETT. Congressman, we have heard this several times today, we have heard that we have strong regulation. I just want to correct the record. When it comes to consumer products, we have extremely weak regulation—

Mr. WALLISON. Yes. I am talking here not about consumer products—

Mr. PLUNKETT. —and that creates systemic risk, and that is why we need an agency.

Mr. GREEN. Excuse me, please. The gentleman, Mr. Wallison, is speaking, and we will have to ask, sir, that you withhold comments until you are requested to speak.

You may continue.

Mr. WALLISON. I was responding, really, to the question of safety and soundness regulation, not consumer products regulation. And on the question of safety and soundness regulation, banking regulation has failed completely. And so, we ought not to have a knee-jerk reaction that says, "Well, we have a problem. Let's regulate it." We ought to step back and see what is wrong with the regulation, why it isn't working.

And one of the ideas that I think we ought to look at, at least, is the notion of making sure that we help the private sector to understand the risks that companies are undertaking. And one of the ways to do that is to assure that companies put out financial information that responds to what the needs of the private-sector lenders are.

Now, one of the things that analysts can do is to supply the regulators with indicators or metrics of risk-taking, because that is the thing that has been causing most of the trouble. And if the private sector were to have that information, they could make much better decisions about where to make their—

Mr. SCOTT. Okay. Mr. Wallison, I don't want to interrupt you, but I only have a few more minutes. I did want to get two more in.

Mr. Plunkett, I know you are itching to get into this fight, so please do.

Mr. PLUNKETT. Well, the only thing I would add is I have heard this now several times, and the flaw in the safety and soundness approach is that the quality of the product wasn't evaluated. It turns out that, if you protect consumers, you will better protect safety and soundness, you will better protect the economy.

So that is the flaw in looking at this very narrowly in terms of just what is traditionally defined as safety and soundness regulation. And that is why we need an agency that is focused solely on protecting consumers.

Mr. SCOTT. Good point.

Mr. Ryan?

Mr. RYAN. I am going to take a very different tack. We have the Group of 30, chaired by Chairman Volcker; we have the Chair of the Fed, Mr. Bernanke; and we have the new Secretary of the Treasury; and we have a very unique situation here. We have most of the people sitting here who represent the industry asking for something which is really new regulation. That is a good sign that we need it. And I think we need it in a very timely fashion, sir.

Thank you.

Mr. SCOTT. Thank you very much.

Thank you, Mr. Chairman.

Mr. GREEN. Mr. Cleaver is now recognized for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman.

The European Union is presently considering establishing a systemic risk council, the E.U. Systemic Risk Council. And from all that I have been able to read, it appears as if that is going to be established.

Do we find ourselves—this is for any of you—do we find ourselves in an awkward spot as a nation if we fail to connect in some kind of way with an international systemic risk operation? I mean, if Europe or maybe then there comes an Asian systemic risk council, what happens to us if we are over here in some kind of isolation?

Yes, Mr. Timothy Ryan?

Mr. RYAN. Thank you. That is what my mother calls me sometimes too, "Mr. Timothy."

We think that there is a need for strong global coordination. The college approach in Europe is principally a result of an inability of them to agree on one central entity to be the systemic risk regulator for the entire E.U. or E.C.

So you have the, I would say, unique authority within the United States to set something up. It would be the first. If done correctly, it would add an awful lot of value. And part of its function would be to coordinate with other groups around the world, whether it is a college or a specific regulator.

Mr. WALLISON. One of the reasons, Congressman, I think the United States is the engine of the world is that we are not subjecting our businesses to excessive regulation. It is clear that the E.U. wants more regulation; they can have it. And they can have systemic regulation, if they want it. But the effect of that is going to reduce economic growth within the E.U. The United States—

Mr. CLEAVER. Why? I hear people say that all the time.

Mr. WALLISON. Because regulation imposes costs, it suppresses innovation, it reduces competition, all of the things which make our system work better.

Mr. CLEAVER. All of the things you just declared, how do you know that? I mean, it suppresses creativity and all that—I mean, how?

Mr. WALLISON. There have been lots of academic studies that have shown that costs are increased by regulation. And it should be clear that happens, because you have to respond to the regulator, you have to provide a lot of reports, you have to make sure that the regulator is approving what you are doing. All of these things add costs to businesses, which are ultimately imposed on consumers.

Mr. CLEAVER. Mr. Silvers?

Mr. SILVERS. I really appreciate that this is my friend Peter Wallison's religion, but I think that the facts are that when we had well-regulated financial markets they channelled capital to productive activity, they were a reasonable portion of our economy and they were not overleveraged and we did not suffer from financial bubbles. And that describes the period from the New Deal until roughly 1980.

And then we started deregulating, and the result was financial markets that grew to unsustainable size, excessive leverage in our economy, an inability to invest capital in long-term productive purposes, an inability to solve fundamental economic problems, and escalating financial bubbles.

That is the history of our country. When we had thoughtful, proportionate financial regulation, it was good for our economy.

Now we are in a position, pursuant to your question, where we have global financial markets and where a global financial regulatory floor is an absolute necessity if we are going to have a stable global economy. If we choose to be the drag on that process, it is not only going to impair our ability to have a well-functioning global financial system, it will damage the United States's reputation in the world.

This question is immediately before us. And I would submit to you that while systemic risk regulation is important here, underneath that are a series of substantive policy choices which will define whether or not we are serious about real reregulation of the shadow markets or not. And if we choose to be once again the defender of unregulated, irresponsible financial practices and institutions, that the world will not look kindly upon us for doing so, as they did not look kindly upon us for essentially bringing these practices to the fore in the first place.

Mr. CLEAVER. Our children won't either. Our children won't look kindly on us.

Ms. Jorde?

Ms. JORDE. I think the point was made earlier that a vast majority of the taxpayer funds that went to AIG were used to make payments to foreign banks, and I don't think anybody here really understands why. Is it because foreign banks have a big stake with our U.S. banks? We really don't know.

And I think that, at the end of the day, we need to get to the bottom of how interconnected is our entire economy, how much are

we dependent on those foreign banks, what stake do they have with us.

Mr. GREEN. The gentleman's time has expired. Mr. Ellison is recognized for 5 minutes.

Mr. ELLISON. Let me thank the entire panel, but my first question is to Mr. Bartlett.

Mr. Bartlett, particularly given that Goldman Sachs and Morgan Stanley are now holding companies, what are your thoughts on the recommendation of the G30 report on financial reform that strict capital and liquidity requirements be placed onproprietary trading activities?

Mr. BARTLETT. I guess I am not familiar with that exact recommendation. I think the G30 report was, by and large—we don't agree with all of it—was, by and large, a step in the right direction.

Those two institutions became bank holding companies. As I understand, they have several years with their primary regulator to conform with all the capital requirements. It is clear that more capital is one of the trends in this, or less leverage. And that is one of the outcomes of becoming a bank holding company.

Mr. ELLISON. Mr. Ryan, what are your views on this?

Mr. RYAN. Excuse me?

Mr. ELLISON. Do you have any reflections on this?

Mr. RYAN. I do have views on this. I think this issue of rules applying to specific activities or products within bank holding companies or within systemically important institutions is within the domain of the existing regulator today, so the Fed has authority to deal with this, from a bank-holding-company standpoint. And, under our proposal, the systemic regulator, who we think is a more appropriate entity, with all of the information, should be making those determinations.

Mr. ELLISON. Thank you.

Mr. Wallison, you know that in 1999, I believe, legislation was passed in our Congress which exempted credit default swaps from regulation. Do you agree that it is the fact that these derivative instruments were not regulated that has created part of the financial crisis we find ourselves in today?

Mr. WALLISON. No, I do not.

Mr. ELLISON. Well, let me ask you this question then. Mortgage originators, who were largely unregulated—as you know, most of the mortgages, the what we call subprime, predatory mortgages were not originated by banks but by unregulated mortgage originators. Do you agree that they contributed significantly to the problem and were unregulated? Do you agree with that?

Mr. WALLISON. Well, yes, I agree with the fact that unregulated mortgage originators did originate a lot of mortgages. But the reason they originated a lot of these mortgages is that they had a place to sell them, which was Fannie Mae and Freddie Mac.

Mr. ELLISON. Well, do you agree that if they had certain requirements on, you know, continuing education, bonding, some standards of behavior, professional standards, that we may not be in this situation to the degree we are in it right now?

Mr. WALLISON. I think that is entirely possible, but—

Mr. ELLISON. Oh, so you agree with regulation at least in that way?

Mr. WALLISON. That is consumer product regulation, and, yes, I think that in many areas consumers need protection, and that might certainly be one of the areas. But the point is that all these things were originated because the money was available through Fannie Mae and Freddie Mac.

Mr. ELLISON. Reclaiming my time, Mr. Silvers, are Fannie Mae and Freddie Mac responsible for this financial crisis we are in now?

Mr. SILVERS. The way Fannie and Freddie were managed, particularly since 2003—and that date is very important—is a substantial contributing factor.

However, the narrative that has been put forward by, essentially, people who have a, sort of, principled disagreement with regulation, that Fannie and Freddie are the primary cause of this problem, is completely and utterly wrong. And specifically, it is completely and utterly wrong because Fannie and Freddie functioned, for example, for 10 years, almost, following the strengthening of the Community Reinvestment Act without bringing on systemic crisis.

They began to do what my friend Peter was talking about when deregulated mortgage markets began to encroach on their market share and in a context in which credit was available broadly without regard to risk because of policies of the Fed and the Bush Administration. And that began in 2003, and that is when you saw the explosion of subprime.

Fannie and Freddie were participants in that conduct starting in 2003. But their existence and the existence of GSEs, the existence of the Community Reinvestment Act are not primarily responsible for this crisis, and to assert so is to fundamentally distort the record.

Mr. ELLISON. Mr. Bartlett, in returning back to you, in a speech that FDIC Chairwoman Bair made recently, she expressed serious concern about the implementation of Basel II internationally, and it might allow for reduction in regulatory capital requirements at the height of a global financial crisis. To address this concern—I think I am all done there, Mr. Chairman.

Mr. GREEN. We will receive a quick answer to the question. Time is up.

Mr. ELLISON. Okay. Can I finish the question?

Mr. GREEN. Yes, sir.

Mr. ELLISON. Okay.

She advocated the application of a global leverage capital requirement, which we already have in the United States.

Could you express your thoughts on those requirements for banks both in the United States and internationally?

Mr. BARTLETT. I think both we and our regulators—our government in Basel II has taken a whole new look at Basel II to determine what to do with it going forward. I think the world has changed in the last 2 years. And so I think we are all just taking a brand-new look at it, including Sheila Bair.

Mr. GREEN. The gentleman's time has expired. Mr. Perlmutter is now recognized for 5 minutes.

Mr. PERLMUTTER. Thank you, Mr. Chairman. And I would note for the record that different regulators, such as yourself now in the

chair, adhere to the 5-minute rule, whereas other regulators, some of the other Chairs didn't quite adhere to the 5-minute rule.

So I just want to say to the panel, many of you have been here before. The information you are providing today and the way you have been thinking about this, the way this has been evolving, really for all of us, over the course of the last year, year and a half, I think we are really developing a lot of agreements.

And now, Mr. Wallison, as much as I want to debate you on a lot of things, I do agree with you on your point about regulation can add to cost and potentially the loss of innovation. But I don't think that is the end of the question. Because, as we have been here and have had hearing after hearing on this subject, the banking system, the financial system, in my opinion, is a different animal that we have to look at in a different way. Because, as we relieved ourselves of regulations, whether it was Glass-Steagall or, you know, change mark-to-market or different kinds of things, people may have been able to make that last buck, but the bottom fell out, so that the taxpayers are paying a ton of money, because the system itself is so critical to how our economy runs and the world's economy runs. I mean, we are obviously seeing how interconnected everything is.

So I agree with you. That is why there has to be reasonable regulation. And the pendulum always swings to too much, and we have seen too little, in my humble opinion, and it is costing us a ton of money.

So, having said that—and it may be that I am just going to give a statement and not ask questions. I generally ask questions, but I want to say—is it Ms. "Jorde?"

I think you had—you made a couple of points that, in my opinion, are critical to this whole discussion. That is, you know, the product mix, what do banks—what is their trade, what is their business, and has there been too much commerce and banking together so that we have products that get outside of a banking regulator's expertise, and then also the size of the institution.

And Congressman Bartlett and I have had this conversation, about the size of the institution. In my opinion, things can get too big. But within the system—so I think we have to look at the product mix. The regulator has to look at the product mix, has to look at the size of the institutions, because they can get too big and outstrip whatever insurance we put out there.

And then there is, sort of, the systemic peace of this, which is the group think, Mr. Plunkett, you talked about, where in Colorado in the 1980's, the savings and loans were not that big, but they all started thinking the same way, they all started doing the same things, and a lot of them got themselves in trouble. Now, if we had had mark-to-market back then, we would have lost every bank in Colorado. Thank goodness we still had at least half of them. So Mr. Yingling's dead on the mark on the mark-to-market stuff.

Mr. Silvers, your points about the stock options and that you can go for the gusto because you have no downside, I really hadn't added that to the whole mix of this. And when it comes to financial institutions, we may have to look at that piece. I think that we do need a super-regulator because there are too many gaps within the system. So whether it is, you know, on top of Mount Olympus, Mr.

Yingling, as you have described, or something, there are too many gaps within the system. We need to have somebody looking at this as a whole.

And so all of you have brought a lot of information to us in a very cogent fashion, and I appreciate it. I mean, this is what it is going to take for us to develop this.

Yes, Mr. Ryan?

Mr. RYAN. I would just like to comment on this issue of too large financial institutions.

Mr. PERLMUTTER. Go for it.

Mr. RYAN. Because I spent a lot of time before this committee when I was a regulator of the OTS and a director of the RTC. And we have large financial institutions for a lot of different reasons. We have them because of consolidation, some of it voluntary, some of it not. Some of our largest institutions are really large because we had to resolve small banks, and the small banks became part of, like, a Bank of America. Think of it back to NCNB.

The idea that we should not have large financial institutions will cut into productivity. It will cut into technology. It will make up us—

Mr. PERLMUTTER. I understand that. And I agree with you. And I think Mr. Wallison is on the same—it is the same point, just a little different. It will cut into it. It will make it more inefficient. But, on the other hand, smaller institutions will compete with one another, and it won't be so hard for the regulator to figure out everything that is going on within the institution. Even if you had to resolve them all together, at some point, you know, they are too big, in my humble opinion.

But thank you. I appreciate it.

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

Mr. PERLMUTTER. Yes, sir. Thank you, Mr. Chairman. I am glad you are keeping watch on the clock.

Mr. GREEN. We will now recognize Mr. Grayson for 5 minutes.

Mr. GRAYSON. Thank you, Mr. Chairman.

Gentlemen, if you were interested in increasing lending at a time when the general perception is that credit is in short supply and that we need to expand credit in order to keep the economy afloat, and you had a choice, and that choice was between bailing out huge institutions that have proven that they were not good at allocating credit by the fact that they lost billions upon billions of dollars versus providing additional credit or even relaxing reserve requirements for healthy institutions that had shown they could take that money and make a profit with it, which would you choose?

Mr. Silvers?

Mr. SILVERS. Well, you know, one of my observations from being on the Oversight Panel for TARP, which I think is, sort of, what you are getting at, is that what is a healthy institution can be a puzzling thing. Every recipient, with the exception of AIG, of TARP money has in some respect been designated a healthy institution by the United States Government. So perhaps your question is, well, we are just giving money to healthy institutions already. I am not sure that is a very plausible statement, but it is, more or less, what the record shows.

The question of increasing lending, I think, is complex. There is no question that there is a need for more credit in our economy right now. On the other hand, the levels of leverage we had in our economy during the last bubble are not ones we ought to aspire to returning to or sustaining. Getting that balance right is extremely important.

And, furthermore, it is also the case, I believe, that allowing very, very large institutions to come apart in a chaotic fashion would be very harmful to our economy.

The punch line is I think that we have not learned enough about to what extent TARP's expenditures have produced the increased supply of credit that your question indicates and to what extent that is because of, I think as you put it, the fact that a majority of that money has gone to a group of very large institutions. Those are questions that I know the Oversight Panel is interested in and questions that I am very interested in. I can't tell you what I believe the answer to them to be today.

Mr. GRAYSON. Ms. Jorde, should we be helping healthy institutions help us, or should we be bailing out institutions that have a history of failure?

Ms. JORDE. Well, we should be helping healthy institutions help us, certainly. I don't anybody is advocating that we allow large institutions to come apart chaotically.

I think that, certainly, if we start to work toward making these institutions smaller—I am not saying we are going to have 100,000 community banks with less than $50 million in assets, but we can certainly make these institutions of such size that capital will come back into them from the sidelines.

I don't think that investors out there are very anxious to be investing in these systematically risky institutions. And I think, going forward, we can have a lot of lending start up again if we plan this right.

Mr. GRAYSON. Mr. Plunkett, if our goal is simply to extend credit and give people the credit that they are used to getting and the credit that they need and to keep the economy as a whole afloat, is it more effective to help healthy institutions expand their lending or is it more effective to give money to failed banks and see that that money goes directly to having them meet their already-overwhelming credit needs internally?

Mr. PLUNKETT. Well, I am going to talk about one aspect of this issue that hasn't been addressed: the need to assure that attempts to spur credit availability, whether through larger institutions or smaller institutions, are offered on a sustainable basis. The TARP program, the TALF program—we are concerned, particularly with the TALF program, that it may end up subsidizing, for instance, credit card loans with terms and conditions that are not sustainable for consumers.

So I think that is an important aspect to the issue that we should think about.

Mr. GRAYSON. I am wondering if there is any way to meet systemic risk threats that does not involve transferring hundreds of billions of dollars from the taxpayers to failed banks.

Mr. Ryan?

Mr. RYAN. Do you mind if I answer the question that you posed to everybody else just for a second, then I will answer this question?

Mr. GRAYSON. Sure, that is fine.

Mr. RYAN. The key to credit availability for consumers right now is securitization. That market is dormant. That market provided over half of the funding for consumers. And if there is anything we could do right now to move that market back to its vibrancy, that would directly impact consumers.

And I think the government could do something. I think they should have used TARP for its original purpose. I think they should have purchased troubled assets, most of which would have been mortgages. They could have also restructured those mortgages and resecuritized them, which would have jump-started this system.

Mr. GRAYSON. Well, fine, but I still would like, with the chairman's indulgence, an answer to my question.

Mr. GREEN. Mr. Grayson, sir, the time has expired. We will have to receive that response in writing.

Mr. RYAN. And I will do that for you.

Mr. GREEN. We will now recognize Mr. Himes for 5 minutes.

Mr. HIMES. Thank you.

And, to the panel, thank you and congratulations. Unless my colleagues from Michigan and New York show up, you are done in 4 minutes.

I have a small question and a large question. The small question is for Mr. Wallison.

Mr. Wallison, I have heard you say on a number of occasions today, "Let them fail." I wonder, knowing what you know about the millions of contracts, insurance contracts, written by AIG, and, of course, now that we know who the counterparties were to many of their CDSs, would you have applied that advice? Would you have simply let AIG fail?

Mr. WALLISON. Yes. I think the Fed panicked on AIG. They should have let it fail. They panicked because, right after Lehman Brothers failed, the market froze, and the Fed thought, at that point, that they had to step in and stop a further disintegration of the market by covering AIG.

The facts are not very well-known—but some substantial portion of what AIG was committed to were credit default swaps. Others were other kinds of obligations. Most of the newspaper commentary and media commentary has been about the credit default swaps.

Now, when an insurance company fails and your house is insured by that company, what you have to do is go out and get another insurance company. You haven't suffered any loss yet until you have that fire or that burglary or whatever it is. So if AIG had failed, the people who were protected by the credit default swaps, the companies that were so protected would have had to have gone out and gotten other credit default swaps if they still thought they were at risk on particular obligations. So that would not have caused any serious problem.

Mr. HIMES. Thank you. And let me reclaim my time because I actually have a larger question. I appreciate that explanation.

My larger question is, with the exception of Mr. Wallison, there is some consensus that we will form and should form a systemic regulator. I get really interested in the question of, how do we make sure that that systemic regulator has the flexibility, the ability to range over the financial landscape, the ability to adapt to what we know is a very rapidly evolving industry?

What attributes, what characteristics, what incentives could we put into the systemic regulator to get it to act in a way that regulators don't typically act, which is entrepreneurial?

Given the limited time, I would ask if we have time to hear from Mr. Bartlett, Mr. Ryan, and Mr. Yingling very briefly on that question.

Mr. BARTLETT. Congressman, I think you give it a broad mandate, and you make the mandate systemic and not individual firms.

I think placing this mandate of a market stability regulator at the Fed is important, because the Fed has that breadth of institutional knowledge. They count the shipment of—or the ordering of corrugated containers. So this would be consistent with the breadth that they look at the economy.

I think those two things: broad mandate and then putting it at an institution that is big enough.

Mr. RYAN. Our view is that one of the most important things for this systemic regulator—and you have heard me say this before—is the ability to see over the horizon, which means information. They need information about all interconnected and important systemic institutions so that we can help the system and help the citizens avoid this type of problem in the future.

And I don't think this is a cure-all for everything, but it certainly would give us something that does not now exist anyplace in the world. And I think we need it now.

Mr. YINGLING. I think your question is very, very important, because, as you are pointing out, there is a tendency in regulatory agencies to fight the previous war.

We talk about the Fed being the systemic regulator. There is another option, and that is you have a council that is headed by the Fed. And whether you use that model or the Fed, I think this needs to be a different group. It needs to be a smaller group. It needs to be people that are not there to fill out forms or read forms or read reports. It has to be people who are looking out and looking at statistics and going out and talking to people. And a prime example is somebody that would look at the growth in subprime mortgages and the 3/27s and 2/28s and look at that chart and say, that is a big fire.

And so, whether it is in the Fed or within a committee headed by the Fed, it ought to be a group that has that role. They don't have a regulatory day-to-day role. Their role is to be entrepreneurial, as you are saying.

Mr. HIMES. Thank you.

I yield back.

Mr. GREEN. The gentleman yields back his time. I will now recognize myself for 5 minutes.

And, in so doing, let me thank all of the witnesses for appearing today. I think your testimony has been most valuable and will surely help us to come to some conclusions.

Let's not talk about a systemic regulator for just a moment, and simply talk about systemic risk, because I think there has been some confusion that has developed. I think Mr. Bartlett, for example, has talked about a methodology by which we can ascertain whether or not systemic risk exists.

And, Mr. Bartlett, I think you have been a little bit misunderstood. Now, that may have been by accident, or it may have been by design. But you have been a little bit misunderstood, because some have tried to attribute to your comments the notion that, once you do this, you are somehow going to bail out an entity or you are going to spend government money.

I don't think that is what you are saying. Is it at all what you are saying, sir?

Mr. BARTLETT. We Texans listen to each other very carefully, Mr. Green. No, you have it exactly right. I said exactly the opposite, that it is identifying the risk so you can avoid the consequences that we are suffering today.

Mr. GREEN. And, Mr. Yingling, I think that you, too, have been a proponent of risk identification. Without simply saying, "This entity is the entity that poses a risk," you, too, have talked about risk identification.

I think, Mr. Silvers, that seems to be your position, as well, risk identification.

Is this correct, as it relates to the two of you? If you have a difference of opinion, kindly extend your hand.

Okay. So, now, given that we have talked about risk identification, let me just ask this: If we do see that a systemic risk exists, is there a belief that we ought to take some action, that we ought to take some action? My suspicion is that most would say yes.

But I am going to move now to Mr.—and the camera is in my way—Mr. Wallison, is that correct?

Mr. WALLISON. Yes.

Mr. GREEN. Mr. Wallison, I seem to have concluded that you, after having identified systemic risk, may not want to take systemic action.

Mr. WALLISON. No. On the contrary, I don't believe that it is possible to identify systemic risk.

Mr. GREEN. You don't think that it is possible to identify it?

Mr. WALLISON. No, I don't.

Mr. GREEN. With AIG—well, let's go back to the GSEs. I got the impression that you were the person who came forward, and, while not using this specific terminology, "systemic risk," you identified them as entities that might provide some risk, significant risk, or considerable risk. Is that true?

Mr. WALLISON. I thought they could, in fact, create systemic risk, of course.

Mr. GREEN. All right.

Mr. WALLISON. Because they were backed by the government.

Mr. GREEN. Let's pursue this. If you conclude that an entity can cause systemic risk, as you came forward with your clarion call, then do you not want to see some action taken to prevent that cause from moving forward, from becoming the cause of the systemic risk?

Mr. WALLISON. Yes.

Mr. GREEN. All right. Well, if you conclude that you want—as you did; you came forward. You, in fact, were sort of a systemic analyzer, if you will. You performed a systemic analysis, in a sense. Do you agree?

Mr. WALLISON. Yes.

Mr. GREEN. Okay. If you conclude that you want to do something about the GSEs, if they may be the cause of systemic risk, can you not conclude that AIG may have been the cause of systemic risk, as well?

Mr. WALLISON. Yes, it is entirely possible that AIG could have been a cause of systemic risk.

Mr. GREEN. All right. And if you realize that AIG is a cause of or may be a cause of systemic risk, would you not want to prevent AIG from being a systemic risk, creating a systemic risk?

Mr. WALLISON. If we were sure that any entity is a cause of systemic risk large enough to have an effect, theoretically, on the rest of the economy, yes, of course, we should do it. But the downside of that—

Mr. GREEN. All right. You are—

Mr. WALLISON. Congressman, the downside of that—

Mr. GREEN. Excuse me, please. I am reclaiming my time.

Mr. WALLISON. Okay.

Mr. GREEN. You are with us, then, because that is what I think most people are saying today. If we identify an institution that may pose systemic risk, then we ought to do something about it.

Which, by the way, is what the taxpayers are saying, too. We all have our opinions, but the taxpayers will probably have the last word. And they want to see institutions, for whatever reasons, that are identified as systemic risks, they want to see us to do something about that. That is what this is all about.

Mr. WALLISON. Yes, I understand. This is your problem. Congress—

Mr. GREEN. I agree. And because it is my problem—

Mr. WALLISON. Congress is required to act.

Mr. GREEN. Hold on, because you have just said something that is exceedingly important. It is my problem.

Mr. WALLISON. Yes.

Mr. GREEN. And because it is my problem, I cannot allow the foxes that have allowed the raid on the henhouse to prevent me from securing the henhouse. It is time for us to secure the henhouse.

Now, this is not directed at you, sir, but those foxes that allowed the raid on the henhouse, they will have a voice. But what I have to do, because it is my problem, is not allow those voices to prevent us from securing the henhouse.

Sorry I had to go back to my bucolic and rustic roots, but I thought it appropriate to make that—

Mr. WALLISON. I think you ought to be aware of unintended consequences that—

Mr. GREEN. And I will be, but I will have to do it and voice it at another time, because my time has expired.

And, recognizing that my time has expired, I now have to indicate that some members may have additional questions for these witnesses that they wish to submit in writing. And, without objec-

tion, the hearing record will be held open for 30 days so that members may submit written questions to these witnesses and place their responses in the record.

I thank all of you for coming. Your commentary has been invaluable.

The hearing is adjourned.

[Whereupon, at 1:26 p.m., the hearing was adjourned.]

A P P E N D I X

March 17, 2009

STATEMENT OF THE
HONORABLE STEVE BARTLETT
PRESIDENT AND CHIEF EXECUTIVE OFFICER
THE FINANCIAL SERVICES ROUNDTABLE

ON

PERSPECTIVES ON REGULATION OF SYSTEMIC RISK
IN THE FINANCIAL SERVICES INDUSTRY

BEFORE

THE COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
MARCH 17, 2009

Chairman Frank, Ranking Member Bachus, and Members of the Committee, I am Steve Bartlett, the President and Chief Executive Officer of the Financial Services Roundtable. The Roundtable represents 100 of the nation's largest integrated financial services firms. Roundtable members provide banking, insurance, and investment products and services to American consumers and businesses.

About three years ago, the Roundtable began to look at the question of how our current regulatory system impaired the competitiveness of the financial services industry through a Blue Ribbon Commission. Over the course of the last three years, this dialogue has evolved into a CEO-driven Executive Council focused on how this current system also undermines the stability and integrity of the financial services industry.

Our conclusions include the following:

1) The financial services industry is regulated by hundreds of separate regulators at various levels. This chaotic system of financial regulation was a contributing factor to the current crisis.

2) That is not to say that it is the only cause – the financial services industry accepts our share of responsibility – badly underwritten mortgages, compensation packages that pay for short term revenue growth instead of long term financial soundness, failure to communicate across sectors, even within the same company, and sometimes, even downright predatory practices – all were part of the crisis but an absence of coherent comprehensive systemic regulatory structure did fail to identify and prevent this crisis. We still have that same regulatory structure today.

3) Reforming and restructuring the regulatory system in 2009 should be Congress's primary mission moving forward to resolve this crisis and prevent another crisis.

4) We are proposing a comprehensive reform of the regulatory structure that includes a new architecture, a consolidation of agencies, clearer lines of authority, and uniform standards both across state lines and types of business. The Roundtable's proposed chart of the new financial architecture is included below and a summary of this reform proposal is attached.

5) We do advocate a systemic risk regulatory regime – what we prefer to call a market stability regulator. However, as you will see further in my testimony, the systemic risk regulator should be "NIFO" – Nose-In-Fingers-Out. That means that a market stability regulator should not replace or add to the primary regulator but rather should identify risks and act through and with a firm's primary regulator.

6) The U.S. regulatory system should be the U.S. system, of course, but should be coordinated with and consistent with international standards. This is a global crisis and a mere domestic solution will not fix it.

I appreciate this opportunity to discuss this important issue with you today. I found a significant number of misconceptions about systemic regulation and regulatory restructuring. Therefore, the structure of my testimony is addressed through frequently asked questions, starting with –

Why is reform needed?

Crises have a way of revealing structural flaws that long existed, but were little noticed until the crises. The on-going crisis in financial markets is no different. It has revealed several structural flaws in our financial regulatory system.

We have a fragmented system of national and state financial regulation that is based upon a concept of "functional" regulation. Under this system, firms are regulated according to their charter type, and there is limited coordination and cooperation between different regulators, even though firms with different charters often engage in the same or similar activities. Moreover, no federal agency is responsible for examining and understanding the risks created by the interconnections between firms and markets – domestically and globally.

This current functional system has resulted in significant, adverse gaps in U.S. financial regulation that permit some financial services firms to operate with minimal oversight and supervision, and it has encouraged firms to engage in regulatory arbitrage.

The regulation of mortgage finance illustrates these structural flaws. No single regulator was accountable for identifying and recommending corrective actions across the mortgage origination, securitization, and insurance process. Most mortgage brokers were not subject to any licensing and qualification requirements. Over half of all mortgage loans were originated by state-licensed lenders and were not subject to supervision or regulation. Other lenders that were regulated were able to engage in practices that did not meet basic safety and soundness or consumer protection standards.

The federal banking regulators recognized many of these problems and took actions to address the institutions within their jurisdiction, but they were slow to act, had

no jurisdiction upstream or downstream, and lacked the power to reach all lenders. Eventually, the Federal Reserve Board's (the Fed) Home Ownership and Equity Protection Act (HOEPA) regulations did extend some consumer protections to a broader range of lenders, but the Fed does not have the authority to ensure that those lenders are engaged in safe and sound underwriting practices or risk management.

The process of securitization suffered from a similar lack of systemic oversight and prudential regulation. No agency had the authority to prohibit the sale of mortgages that were poorly underwritten. Likewise, no agency was responsible for addressing the over-reliance investors placed upon the credit rating agencies to rate mortgage-backed securities. Moreover, under our state-based system of insurance regulation, no federal agency was paying attention to the role of the mortgage insurance industry and other insurance companies that contribute to the mortgage origination and securitization process.

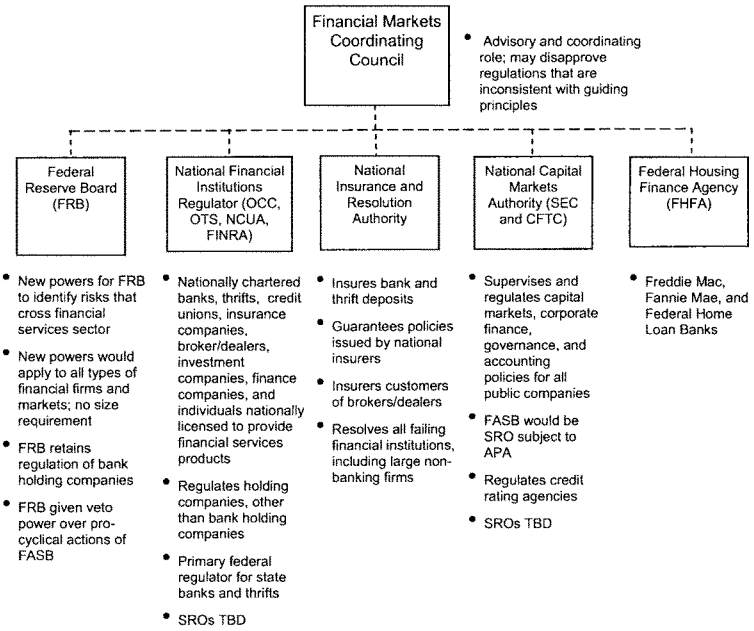
How do you propose to fix these structural flaws in the existing financial regulatory system?

The Roundtable has developed a proposed "Financial Regulatory Architecture" to address the flaws in our current system. Our proposed architecture is designed to:

- Limit systemic risk;
- Reduce regulatory overlap and close gaps in regulation;
- Provide for greater coordination among all financial regulators;
- Promote uniform regulation and supervision; and
- Preserve state financial regulation.

The following chart illustrates our proposed regulatory architecture.

FINANCIAL REGULATORY ARCHITECTURE PROPOSAL



The six components of this proposed architecture are as follows. First, to enhance coordination and cooperation among the many and various financial regulatory agencies, we propose to expand membership of the President's Working Group on Financial Markets (PWG) and rename it as the Financial Markets Coordinating Council (Council). This Council should be established by law, in contrast to the existing PWG which has

operated under a Presidential Executive Order dating back to 1988. This would permit Congress to oversee its Council's activities. The Council should include representatives from all major federal financial agencies, as well as individuals who can represent state banking, insurance and securities regulation. The Council should serve as a forum for national and state financial regulators to meet and discuss regulatory and supervisory policies, share information, and develop early warning detections.

The Council should not have independent regulatory or supervisory powers. However, it might be appropriate for the Council to have some ability to review the goals and objectives of the regulations and policies of federal and state financial agencies, and thereby, ensure that they are consistent.

Second, to address systemic risk, we propose that the Fed should be authorized to act as a market stability regulator. As a market stability regulator, the Fed should be responsible for looking across the entire financial services sector to identify interconnections that could pose a risk to the financial system. I address this function in greater detail later in my testimony.

Third, to reduce gaps in regulation, we propose the consolidation of several existing federal agencies into a single, National Financial Institutions Regulator (NFIR). This new agency would be a consolidated prudential and consumer protection agency for banking, securities and insurance. The NFIR would reduce regulatory gaps by establishing comparable prudential standards for all of these nationally chartered or licensed entities. For example, national banks, federal thrifts and federally licensed brokers/dealers that are engaged in comparable activities should be subject to comparable

capital and liquidity standards. Similarly, all federally chartered insurers would be subject to the same prudential and market conduct standards.

In the area of mortgage origination, the NFIR's prudential and consumer protection standards should apply to both national and state lenders. Mortgage lenders, regardless of how they are organized, should be required to retain some of the risk for the loans they originate. Likewise, mortgage borrowers, regardless of where they live or who their lender is, should be protected by the same safety and soundness and consumer standards.

Fourth, to focus greater attention on the stability and integrity of financial markets, we propose the creation of a National Capital Markets Agency (NCMA) through the merger of the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC), preserving the best features of each agency. The NCMA would regulate and supervise capital markets and exchanges. As noted above, the existing regulatory and supervisory authority of the SEC and CFTC over firms and individuals that serve as intermediaries between markets and customers, such as broker/dealers, investment companies, investment advisors, futures commission merchants, and other intermediaries would be transferred to the NFIR. The NCMA also should be responsible for establishing standards for accounting, corporate finance, and corporate governance for all public companies.

Fifth, to protect depositors, policyholders, and investors, we propose the creation of the National Insurance and Resolution Authority (NIRA) to act as an insurer of bank deposits, as the guarantor of retail insurance policies written by nationally chartered insurance companies, and a financial backstop for investors who have claims against

broker/dealers. These three insurance systems would be legally and functionally separated. Additionally, this agency should be authorized to act as the receiver for large non-bank financial services firms. The failure of Lehman Brothers illustrated the need for such a better system to address the failure of large non-banking firms.

Finally, to supervise the Federal Home Loan Banks and to oversee the emergence and future restructuring of Fannie Mae and Freddie Mac from conservatorship, we propose that the Federal Housing Finance Agency remain in place, pending a thorough review of the role and structure of the housing GSEs in our economy.

Are you not just rearranging regulatory boxes?

No. This proposal places authority and accountability at specific regulatory agencies and further requires those agencies to adopt coherent and consistent standards. Achieving better and more effective regulation does require more than just rearranging regulatory assignments. Consolidation of overlapping regulatory functions and greater coordination between the remaining agencies will be beneficial, but better and more effective regulation also requires: (1) greater reliance on principles-based regulations that are responsive to changes in market conditions and are focused on desired regulatory results; (2) greater reliance on a system of prudential supervision that is based upon an on-going exchange of information between regulated firms and regulators that seeks to solve common problems before they pose a risk to consumers or the financial system; and (3) a reduction in the pro-cyclical effects of regulatory and accounting requirements, including capital requirements.

As I testified last year in front of this Committee, the final report of our Blue Ribbon Commission recommended that Congress enact a set of principles to guide all financial regulators and regulated institutions. Our proposed Guiding Principles were: fair treatment for consumers as our number one principle; competitive and innovative financial markets; proportionate, risk-based regulation; prudential supervision and enforcement; options for serving consumers; and management responsibilities.

These principles would help regulators and financial services firms focus on desired policy outcomes and material risks to markets. They would not replace regulations. Regulations will remain necessary, especially at the retail level for the protection of consumers. However, a statutory set of guiding principles could serve as a touchstone against which all existing and proposed regulations could be evaluated in a policy and legal context. Regulations that were not consistent with the principles would be identified and revised to be consistent with the principles. Our proposed Financial Markets Coordinating Council could help to perform this function.

Our Blue Ribbon Commission also advocated the application of prudential supervision by all financial regulators. Prudential supervision is a form of supervision in which regulators and regulated entities maintain a constructive engagement to ensure an effective level of compliance with applicable laws and regulations. In other words, prudential supervision promotes the identification and correction of problems before they harm consumers. Prudential supervision relies upon regular and open communications between firms and regulators to discuss and address issues of mutual concern as soon as possible. Prudential supervision encourages regulated entities to bring matters of concern to the attention of regulators early and voluntarily. Prudential supervision promotes and

acknowledges self-identification and self-correction of control weaknesses, thereby reinforcing continued focus and attention on sound internal controls.

Finally, pro-cyclical regulatory and accounting requirements have exacerbated the current crisis in our financial markets. These effects have been seen in the areas of capital requirements, accounting for assets held by institutions, purchase accounting, accounting for annual pension expenses, mergers/acquisitions, adjustment of loan loss reserves, and auction rate securities. U.S. accounting policy is created at the Financial Accounting Standards Board (FASB), an independent regulatory agency. However, the lack of authority over FASB has only exacerbated the pro-cyclical effects of the current accounting standards. Better and more effective regulation should minimize these pro-cyclical effects.

Where does consumer protection fit in your proposed architecture?

This crisis illustrates the nexus between consumer protection regulation and safety and soundness regulation. Safety and soundness regulation is the first line of defense and the strongest weapon for protecting the interests of all consumers. It ensures that financial services firms are financially sound, and in a position to serve consumers. In turn, consumer protection regulation ensures that consumers are treated fairly – the Roundtable's first principle as I just mentioned. This connection can be seen in mortgage underwriting standards. Mortgage underwriting standards not only help to ensure that loans are made to qualified borrowers, but they also help to ensure that the lender gets repaid and can remain solvent. Put another way, safety and soundness and consumer protection are self-reinforcing – each strengthens the other.

Further, safety and soundness regulators have the most powerful tools to enforce their regulations – an unlimited array of powers to enforce consumer protection. We cannot conceive a separate consumer protection agency that could have these same tools. Given this nexus between consumer protection and safety and soundness, our proposed National Financial Institutions Regulator would combine both consumer protection and safety and soundness regulation and supervision.

Where does the regulation of insurance fit in your proposed structure?

Federal regulation of insurance is one of the key gaps in our current financial regulatory system. As the market stability regulator interacts with other regulators, there is an evident need to create a national insurance regulator for the insurance industry, which the Group of Thirty has endorsed recently. Insurance is a national and global business that has over $1 trillion under management, including municipal and corporate securities, and yet, it lacks a national insurance prudential regulator. Only through coordination with a national insurance regulator, will a market stability regulator have the ability to both detect, and act upon, risky market activity and business practices in a timely, uniform, and comprehensive fashion. Asking the market stability regulator to seek coordinated actions by multiple state insurance regulators is not an option that will effectively address systemic risk due to the different state and territorial insurance regulators, with varying legal and budget authority, and different levels of expertise.

A national insurance regulator should have the authority to charter insurance companies, establish and enforce uniform national standards for all factors material to the solvency of nationally chartered insurance companies and the protection of consumers,

and represent the U.S. internationally on behalf of federally chartered institutions. The national insurance regulator's authority should be an independent bureau within a federal agency headed by a Presidential appointee.

Does creating a national insurance regulator create regulatory redundancy?

Some may say that creating a national insurance regulator creates regulatory redundancy. The Roundtable does not believe this is accurate. Just as the dual banking system works well for the industry and the economy – so will the dual insurance system. It would provide companies the ability to decide which system, state or national, works best to serve their customers. Regardless, there should be common principles in the national and state insurance systems. We commend Congresswoman Melissa Bean and Congressman Ed Royce for their tireless work on this specific issue, and we look forward to working with this Committee toward the creation of a national insurance regulator to enhance stability in our national insurance markets and reduce systemic risk in the future.

How do you define systemic risk?

There are many potential definitions, ours is as follows:

> Systemic risk is an activity or practice that crosses financial markets or financial services firms, and which, if left unaddressed would have a <u>significant, material and adverse</u> effect on financial services firms, financial markets, or the U.S. economy.

It also is important to state what systemic risk is not. It is not a risk based only the size or complexity of an organization. Nor is it a risk confined to an identified list of companies or segment of the financial services industry.

Why do you pick the Fed as the market stability regulator?

There are several possible options: a new agency; the Treasury Department, the new Financial Markets Coordinating Council (as outlined in our proposal), or the Fed as the Roundtable and many have proposed. Designating the Fed is a natural complement to the Board's existing role as the nation's central bank and lender of last resort. In its capacity as the nation's central bank, the Fed is required to focus attention on all sectors of our economy. Thus, the Fed has the institutional knowledge and perspective to be a market stability regulator.

Giving this authority to a new agency would require the establishment of a new bureaucracy. Giving this authority to the Fed would only require the Fed to reorganize its existing staff.

If the Fed is designated as the market stability regulator, it would need to establish a clear and transparent governance structure to minimize any potential conflicts with its existing responsibilities.

Also, we would recommend that the Fed establish an Advisory Council on Market Stability to review activities and practices that may pose a systemic risk, balanced against the need for continuing market innovation and competitiveness. The Advisory Council should include representatives of domestic and international financial services firms

doing business in the United States as well as representatives of consumers of financial services.

Does this create a new regulator or make the Fed a super regulator?

The market stability regulator should **not** be just another layer of regulation added to the existing system; it should **not** be a "super-regulator". It should gather information with the assistance of other regulators, conduct joint examinations with other regulators, and, absent an emergency, take corrective actions with and through other financial regulators.

What is the role of a market stability regulator?

The purpose of a market stability regulator should be to promote the long-term stability and integrity of the nation's financial markets and financial services firms by identifying and addressing significant risks to the financial system as a whole.

A market stability regulator should be authorized to oversee all types of all financial markets and all financial services firms, whether regulated or unregulated. However, a market stability regulator should **not** focus on financial services firms based upon size. The designation of "systemically significant financial services firms" would have unintended competitive consequences and increase moral hazard as these firms would be deemed "too big to fail."

Does the establishment of a market stability regulator lead to institutions that are too big to fail?

No, the establishment of a market stability regulator should have the reverse effect. It should mitigate excessive risk, but not prevent failures.

Will a market stability regulator stifle innovation?

Congress should, by statute, require a market stability regulator to balance the identification of activities or practices that pose a systemic risk against the need for continuing market innovation and competitiveness. A market stability regulator should not stifle innovation, or preclude isolated failures. Companies engaged in overly risky activities should be permitted to fail.

What prevents a market stability regulator from becoming another prudential regulator?

Congress also should direct a market stability regulator to focus attention on factors that present the greatest potential for systemic risk, such as excessive concentrations of assets or liabilities, rapid growth in assets or liabilities, high leverage, a mismatch between long-term assets and short-term liabilities, currency mismatch, and regulatory gaps. A market stability regulator should **not** focus attention on products or practices that pose little or no systemic risk.

How would a market stability regulator function?

The market stability regulator should identify, prevent, and mitigate systemic risk by –

- Collecting and analyzing data from other financial regulators and individual financial services firms to understand potential or existing systemic risks in the

financial system. Data on individual firms should be treated as confidential supervisory information;

- Establishing a surveillance system for activities and practices to detect early crisis warning signs and vulnerabilities, conduct scenario planning, and develop contingency planning with other prudential financial regulators across all financial markets;
- Examining individual financial services firms. If a firm is regulated by another national or state financial regulator, such examinations should be coordinated with such regulator. Examination results should be treated as confidential supervisory information;
- Issuing, as necessary, reports and public notices on activities or practices that may pose a systemic risk; and
- Taking corrective actions to prevent or address systemic risk.

To help prevent the market stability regulator from becoming a "super-regulator," we would recommend that, absent an emergency situation, the market stability regulator take actions through other regulators. In other words, in non-emergency times, the market stability regulator should be authorized to make recommendations to other regulators and Congress to address activities and practices that could pose a systemic risk, but do not pose an immediate systemic risk.

Whenever the market stability regulator identifies a practice or activity that could pose a systemic risk and such practice or activity is within the jurisdiction of another national or state financial regulator, the market stability regulator should issue a finding

and recommend appropriate preventive actions to the other regulator. The market stability regulator also should submit any such findings and recommendations to the Congress and our proposed the Financial Markets Coordinating Council (Council). If the other regulator disagrees with the market stability regulator's finding and recommendation, then the regulator can submit its own findings and recommendations to the Congress and the Council. In other words, the Congress and the Council can serve as mechanisms to ensure that recommendations of the market stability regulator are appropriately addressed by prudential regulators.

If the market stability regulator identifies an activity or practice that could pose a systemic risk, and such activity or practice is not subject to regulation or supervision by another regulator – a clear regulatory gap – then the market stability regulator should make a recommendation to Congress on how best to regulate and supervise such activity or practice in the future.

The market stability regulator should be authorized to take unilateral actions to address activities or practices only when the market stability regulator determines that they pose an immediate, systemic risk, which could not be addressed in a timely fashion if the market stability regulator were to recommend actions by any other regulator. Such unilateral actions would include the power to issue orders or regulations affecting activities or practices of individual firms or categories of firms. Such unilateral actions should be approved by a super majority of the members of the Fed, and should be agreed to by the Secretary of the Treasury, who must consult with the President. Such unilateral actions also should be reported immediately to Congress. This authority would be in addition to the Fed's existing authority under section 13(3) of the *Federal Reserve Act* to

extend credit to financial or non-financial institutions in "unusual and exigent" circumstances. The Board should retain that authority.

If market stability regulator had been in place before this crisis, how would it have impacted the crisis?

If a market stability regulator had been in place prior to these events, we would have expected that regulator to have identified many of the risks that cut across firms and markets and contributed to the crisis. For example, I can think of a couple activities or practices that a market stability regulator could have flagged, and, if such activities and practices had been adjusted, the current crisis would have been less severe. First, it is now clear that one of the practices that contributed to the current crisis was excessive leverage by large financial services firms, especially investment banks. A market stability regulator could have identified this leverage and urged the SEC to take corrective actions. Higher capital levels would have reduced the size and scope of this crisis.

Another practice that contributed to the current crisis was growth in non-traditional mortgage instruments. A market stability regulator might have recognized the value of these innovations for certain consumers, as well as the risk to other consumers. The market stability regulator could then have recommended standards for such products long before the banking agencies acted on their own joint guidance.

Would the market stability regulator have identified all systemic risks? Clearly, the answer to that question is no. However, had a market stability regulator been in place, we believe this current crisis would have been less severe.

How do your proposals compare to proposals made by others?

Frankly, I have been surprised by the degree to which our proposals are similar to others. Our proposals are broadly consistent with the reforms proposed in former Treasury Secretary Henry Paulson's Blueprint for a Modernized Financial Structure. His plan called for the establishment of a regulatory system based upon "objectives" rather than "functions". Our proposed streamlining of federal regulatory agencies, combined with guiding regulatory principles and the application of prudential supervision by financial regulators is an objectives-based approach to financial regulation.

Our proposals also are generally consistent with recent recommendations made by the Group of Thirty report. One area where we would differ with the Group of Thirty report would be in the formal designation of systemically significant institutions. As I have noted earlier, we believe that such a designation would have significant, negative competitive consequences for other firms and would create a potential for designated firms to take excessive risk because they were perceived to be too big to fail.

Our proposals are consistent with several positions taken by the Chairman of the Fed. Chairman Bernanke has supported a more principles-based approach to regulation in the past, and better and more comprehensive prudential supervision of all financial institutions, as we do. Chairman Bernanke supports new approaches to capital and accounting issues to reduce their procyclicality and negative impact in down times, and so do we. Chairman Bernanke supports an orderly resolution scheme to resolve troubled and failing nonbank financial institutions, a position the Roundtable fully endorses. Chairman Bernanke supports the creation of a market stability regulator, which he calls a macroprudential regulator. As I have discussed above, we support the creation of market stability regulator, and would propose to give this role to the Fed.

Finally, in closing, I would like to address –

Why act now? Why act in comprehensive manner?

The root causes of the on-going financial crisis are twofold. The first was a breakdown in policies, practices, and processes at many, but not all, financial services firms. The second was our fragmented system of financial regulation.

The industry practices that contributed to the crisis are well documented: Poor loan underwriting standards and credit practices, excessive leverage, misaligned incentives, less than robust risk management and corporate governance. However, since 2007 the industry has taken actions to correct these practices. Underwriting standards have been upgraded, credit practices have been reviewed and recalibrated, leverage has been reduced as firms have rebuilt capital, incentives have been realigned, and some management teams have been replaced.

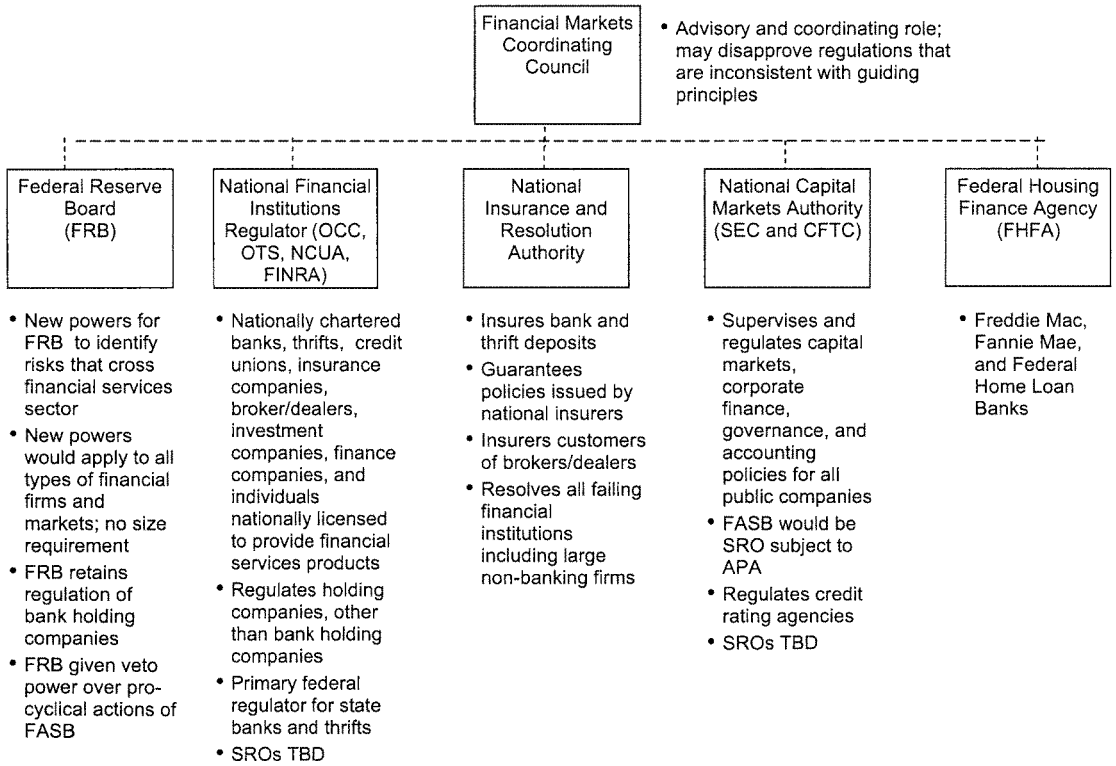
The second cause of the crisis, our fragmented financial regulatory system, has yet to be addressed. Such reform is necessary to help minimize the potential for a repeat of this crisis.

Moreover, we believe that these reforms should proceed in a comprehensive fashion, rather than a piece-meal fashion. Comprehensive reform ensures that our nation's regulatory agencies function in a complementary manner that serves the best interest of consumers, financial services firms, and the economy as a whole.

The key is to do this correctly, not rapidly.

We look forward to working with the Committee in the weeks and months ahead on needed reforms.

FINANCIAL REGULATORY ARCHITECTURE PROPOSAL



The Financial Services Roundtable *March 2, 2009*

FINANCIAL SERVICES ROUNDTABLE
PROPOSAL FOR FINANCIAL REGULATORY REFORM

In anticipation of the most sweeping financial regulatory reforms since the Great Depression, the Financial Services Roundtable's Executive Advisory Council on Regulatory Restructuring has developed six proposals for financial regulatory reform. The first proposal addresses the need for a modern financial regulatory architecture, and the remaining proposals address new regulatory standards to guide the behavior of all financial services firms and regulators.

Six Proposals for Financial Regulatory Reform

1. New Architecture. *Our financial regulatory system should be better aligned with modern market conditions and developing global standards.*

2. Consumer and Investor Protection Standards. *Financial services firms engaged in offering comparable products and services should be subject to comparable prudential, consumer, and investor protection standards. In the event of multiple oversight authorities, uniform standards should apply nationwide.*

3. Balanced and Effective Regulation. *Financial regulation should be focused on outcomes, not inputs, and should seek a balance between the stability and integrity of financial services firms and markets, consumer protection, innovation, and global competitiveness.*

4. International Cooperation and National Treatment. *U.S. financial regulators should coordinate and harmonize regulatory and supervisory policies with international financial regulatory authorities, and should continue to treat financial services firms doing business in the United States as they treat U.S. financial services firms. The United States should continue to play a leadership role in the current G-20 process to develop new international norms for financial regulation across markets.*

5. Failure Resolution. *Financial regulation should provide for the orderly resolution of failing financial services firms to minimize systemic risk.*

6. Accounting Standards. *U.S. financial regulators should adjust current accounting standards to account for the pro-cyclical effects of the use of fair value accounting in an illiquid market. Additionally, U.S. and International financial regulators should coordinate and harmonize regulatory policies to develop accounting standards that achieve the goals of transparency, understandability and comparability.*

Discussion of Proposals

The on-going crisis in world financial markets has revealed both market failures and fundamental weaknesses in the U.S. financial regulatory system. Our fragmented financial regulatory system has resulted in gaps in regulation, which allowed imprudent lending and investment practices by both regulated and unregulated financial firms. Our diverse national and state financial regulatory agencies do not share a common vision and approach to supervision. There is no coordinating body where all regulators can meet to identify problems, exchange information, and devise solutions. Our rules-based system of regulation makes it difficult for regulators and firms to adjust policies and practices in response to rapidly changing market developments.

The Roundtable's six proposals are intended to guide the reform of the financial regulatory system. The Proposals would not only enable regulators to focus on desired policy outcomes and material risks to markets, but also reduce the potential for consumers to fall through gaps between the national and state legal and regulatory systems.

Proposal 1. New Architecture — *Our financial regulatory system should be better aligned with modern market conditions and developing global standards.*

Proposal 1 calls for the existing financial regulatory system to be better aligned with modern market conditions. The "Draft Financial Regulatory Architecture" that is described below is one possible approach to meeting this proposal. The "Draft Financial Regulatory Architecture" is designed to: preserve state financial regulation; provide for greater coordination among all financial regulators; provide for national regulation for insurance companies and insurance producers; reduce regulatory overlap; promote uniform regulation and supervision; limit systemic risk; and create a failure resolution mechanism for non-banking financial firms.

Financial Markets Coordinating Council

To enhance coordination and cooperation among the many and various financial regulatory agencies, we propose to expand membership of the President's Working Group on Financial Markets (PWG) and rename it as the Financial Markets Coordinating Council (FMCC). This Council should be established by law, in contrast to the existing PWG which has operated under a Presidential Order. This would permit Congress to oversee its Council's activities. The Council should include representatives from all major federal financial agencies, as well as individuals who can represent state banking, insurance and securities regulation. The Council should serve as a forum for national and state financial regulators to meet and discuss regulatory and supervisory policies, share information, and develop early warning detections.

The Council should not have independent regulatory or supervisory powers. However, it might be appropriate for the Council to have some ability to review the goals and objectives of the regulations and policies of federal and state financial agencies, and thereby ensure that they are consistent.

Federal Reserve Board

To address systemic risk, the Federal Reserve Board (Board) should be authorized to act as a market stability regulator. As a market stability regulator, the Board should be responsible for looking across the entire financial services sector to identify interconnections that could pose a risk to the financial system. To perform this function, the Board should be empowered to collect information on financial markets and financial services firms, to participate in joint examinations with other regulators, and to recommend actions to other regulators that address practices that pose a significant risk to the stability and integrity of the U.S. financial services system. The Board's authority to collect information should apply not only to depository institutions, but also to all types of financial services firms. This authority should not be based upon the size of an institution. It is possible that a number of smaller institutions could be engaged in activities that collectively pose a systemic risk. As the market stability regulator, the Board must work in coordination with the primary regulators of the financial services firms.

National Financial Institutions Regulator

To reduce gaps in regulation, we propose the consolidation of several existing federal agencies into a single, National Financial Institutions Regulator (NFIR). This new agency would be a consolidated prudential and consumer protection agency for banking, securities and insurance. The NFIR would reduce regulatory gaps by establishing comparable prudential standards for all of these of nationally chartered or licensed entities. For example, national banks, federal thrifts and federally licensed brokers/dealers that are engaged in comparable activities should be subject to comparable capital and liquidity standards. Similarly, all federally chartered insurers would be subject to the same prudential and market conduct standards. Each industry would be legally and functionally separated within the NFIR.

In the area of mortgage origination, the NFIR's prudential and consumer protection standards should apply to both national and state lenders. Mortgage lenders, regardless of how they are organized, should be required to retain some of the risk for the loans they originate. Likewise, mortgage borrowers, regardless of where they live or who their lender is, should be protected by the same safety and soundness and consumer standards.

National Capital Markets Agency

To focus greater attention on the stability and integrity of financial markets, we propose the creation of a National Capital Markets Agency through the merger of the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC), preserving the best features of each agency. The NCMA would regulate and supervise capital markets and exchanges. As noted above, the existing regulatory and supervisory authority of the SEC and CFTC over firms and individuals that serve as intermediaries between markets and customers, such as broker/dealers, investment companies, investment advisors, and futures commission merchants, and other intermediaries would be transferred to the NFIR. The NCMA also should be responsible for establishing standards for accounting, corporate finance, and corporate governance for all public companies.

National Insurance Resolution Authority

To protect depositors, policyholders, and investors, we propose the creation of the National Insurance and Resolution Authority (NIRA) to act as the insurer of bank deposits, the guarantor of retail insurance policies written by nationally chartered insurance companies, and a financial backstop for investors who have claims against broker/dealers. These three insurance systems would be legally and functionally separated. Additionally, this agency should be authorized to act as the receiver for large non-bank financial services firms. The failure of Lehman Brothers illustrated the need for such a better system to address the failure of large non-banking firms.

Federal Housing Finance Agency

To supervise the Federal Home Loan Banks and to oversee the emergence and future restructuring of Fannie Mae and Freddie Mac from conservatorship we propose that the Federal Housing Finance Agency remain in place, pending a thorough review of the role and structure of the housing GSEs in our economy.

Proposal 2. Common Prudential and Consumer and Investor Protection Standards. *Financial services firms engaged in offering comparable products and services should be subject to comparable prudential, consumer, and investor protection standards. In the event of multiple oversight authorities, uniform standards should apply nationwide.*

This proposal calls for comparable prudential standards (e.g., capital requirements and financial reporting) for financial services firms engaged in comparable activities. Such standards would reduce the potential for regulatory arbitrage and the potential for gaps in regulation. The proposal also calls for comparable consumer and investor protection standards for specific financial products and services. For example, residential mortgage loans should be subject to the same consumer protection standards regardless of what type of entity offers the loan. This would ensure that consumers are protected, regardless of where they live.

Proposal 3. Balanced and Effective Regulation — *Financial regulation should be focused on outcomes, not inputs, and should seek a balance between the stability and integrity of financial services firms and markets, consumer protection, innovation, and global competitiveness.*

Balanced, effective regulation requires: (i) greater reliance on principles-based regulations that are responsive to changes in market conditions and are focused on desired regulatory results; (ii) greater reliance on a system of prudential supervision that is based upon an on-going exchange of information between regulated firms and regulators that seeks to solve common problems before they pose a risk to consumers or the financial system; and (iii) a reduction in the pro-cyclical effects of accounting and capital requirements.

Proposal 4. International Cooperation and National Treatment — *U.S. financial regulators should coordinate and harmonize regulatory and supervisory policies with international financial regulatory authorities, and should continue to treat financial services firms doing*

business in the United States as they treat U.S. financial services firms. The United States should continue to play a leadership role in the current G-20 process to develop new international norms for financial regulation across markets.

This proposal calls for the coordination of international financial regulations and the continuation of the national treatment for foreign firms doing business in the United States. The on-going financial crisis indicates that global financial markets require coordination and cooperation among financial regulatory authorities. Also, the benefits of national treatment for foreign firms operating in the U.S. are proven. National treatment promotes open, fair competition not only in the U.S., but abroad.

Proposal 5. Failure Resolution — *Financial regulation should provide for the orderly resolution of failing financial services firms to minimize systemic risk.*

This proposal calls for the establishment of orderly resolution procedures to apply to large non-banking firms. The failure of Lehman Brothers illustrated the limitations of existing receivership procedures. As discussed above, it is envisioned that the National Insurance Resolution Agency would perform this function.

Proposal 6. Accounting Standards — *U.S. financial regulators should adjust current accounting standards to account for the pro-cyclical effects of the use of fair value accounting in an illiquid market. Additionally, U.S. and International financial regulators should coordinate and harmonize regulatory policies to develop accounting standards that achieve the goals of transparency, understandability and comparability.*

This proposal calls for a review of the use of current accounting standards, such as fair value accounting and impairment accounting, when there is an illiquid market. Accounting requirements to write-down securities to observable prices encourages some companies to sell sooner than they otherwise would, further depressing prices in an illiquid market. Problematic pro-cyclical effects have created further problems in the areas of purchase accounting, accounting for annual pension expenses, mergers/acquisitions, adjustment of loan loss reserves, and auction rate securities. This proposal also recommends that the U.S. work with International Regulators to develop and harmonize accounting standards around the globe, providing both U.S. and foreign companies the opportunity to remain competitive in a global marketplace.

Testimony of

Terry Jorde
President/CEO
CountryBank USA
Cando, ND
&
Immediate Past Chairman
Independent Community Bankers of America
Washington, DC

Before the
Congress of the United States
House Committee on Financial Services

on

Regulation of Systemic Risk in the Financial Services Industry

March 17, 2009
Washington, D.C

Mr. Chairman, Ranking member Bachus and members of the committee, my name is Terry Jorde, President and CEO of CountryBank USA. I am also Immediate Past Chairman of the Independent Community Bankers of America.[1] My bank is located in Cando, North Dakota, a town of 1,300 people where the motto is, "You Can Do Better in Cando." CountryBank has 28 full time employees and $45 million in assets. ICBA is pleased to have this opportunity to testify today on regulation of systemic risk in the financial services industry.

Summary of ICBA Systemic Risk Recommendations

ICBA commends the committee for tackling this issue quickly. The current crisis demands bold action, and we recommend the following:

- Congress should direct a fully staffed interagency task force to immediately identify financial institutions that pose a systemic risk to the economy.
- These institutions should be put immediately under prudential supervision by a Federal agency – most likely the Federal Reserve.
- The Federal systemic risk agency should impose two fees on these institutions that would:
    - compensate the agency for the cost of supervision; and
    - capitalize a systemic risk fund comparable to the FDIC's Deposit Insurance Fund.
- The FDIC should impose a systemic risk premium on any insured bank that is affiliated with a firm that is designated as a systemic risk institution.
- The systemic risk regulator should impose higher capital charges to provide a cushion against systemic risk.
- The Congress should direct the systemic risk regulator and the FDIC to develop procedures to resolve the failure of a systemic risk institution.
- The Congress should direct the interagency systemic risk task force to order the break up of systemic risk institutions over a five year period.
- Congress should direct the systemic risk regulator to review all proposed mergers of major financial institutions and to block any merger that would result in the creation of a systemic risk institution.

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[1] *The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 268,000 Americans, ICBA members hold more than $908 billion in assets, $726 billion in deposits, and more than $619 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

- Congress should direct the systemic risk regulator to block any financial activity that threatens to impose a systemic risk.

The only way to maintain a vibrant banking system where small and large institutions are able to fairly compete – and to protect taxpayers – is to aggressively regulate, assessing, and eventually break up those institutions posing a risk to our entire economy.

Congress Must Address Excessive Concentration

ICBA remains deeply concerned about the continued concentration of banking assets in the U.S. The current crisis has made it painfully obvious that the financial system has become too concentrated, and – for many institutions – too loosely regulated.

Today, the four largest banking companies control more than 40% of the nation's deposits and more than 50% of the assets held by U.S. banks. We do not believe it is in the public interest to have four institutions controlling most of the assets of the banking industry. A more diverse financial system would reduce risk, and promote competition, innovation, and the availability of credit to consumers of various means and businesses of all sizes.

Our nation is going through an agonizing series of bankruptcies, failures and forced buy-outs or mergers of some of the nation's largest banking and investment houses that is costing American taxpayers hundreds of billions of dollars and destabilizing our economy. The doctrine of too big – or too interconnected – to fail, has finally come home to roost, to the detriment of American taxpayers. Our nation cannot afford to go through that again. Systemic risk institutions that are too big or inter-connected to manage, regulate or fail should either be broken up or required to divest sufficient assets so that they no longer pose a systemic risk.

In a recent speech Federal Reserve Chairman Ben S. Bernanke outlined the risks of the too-big-to-fail system:

> [T]he belief of market participants that a particular firm is considered too big to fail has many undesirable effects. For instance, it reduces market discipline and encourages excessive risk-taking by the firm. It also provides an artificial incentive for firms to grow, in order to be perceived as too big to fail. And it creates an unlevel playing field with smaller firms, which may not be regarded as having implicit government support. Moreover, government rescues of too-big-to-fail firms can be costly to taxpayers, as we have seen recently. Indeed, in the present crisis, the too-big-to-fail issue has emerged as an enormous problem.[2]

The Chairman of the FDIC, Sheila Bair, appearing on 60 Minutes, recently suggested that too-big-to-fail institutions shouldn't be allowed to exist in the

[2] Financial Reform to Address Systemic Risk, at the Council of Foreign Relations, March 10, 2009

future. She said, "I think we need to really review the size of these institutions and whether we should do something about that, frankly."[3] The Group of 30 report on financial reform stated that, "To guard against excessive concentration in national banking systems, with implications for effective official oversight, management control, and effective competition, nationwide limits on deposit concentration should be considered at a level appropriate to individual countries."[4]

The 10% nationwide deposit concentration cap established by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 should be immediately reduced and strengthened. The current cap is insufficient to control the growth of systemic risk institutions the failure of which will cost taxpayers dearly and destabilize our economy.

Unfortunately, government interventions necessitated by the too-big-to-fail policy have exacerbated rather than abated the long-term problems in our financial structure. Through Federal Reserve and Treasury orchestrated mergers, acquisitions and closures, the big have become bigger.

Congress should take chairman Bair's suggestion and not only consider breaking up the largest institutions, but order that it take place. It is clearly not in the public interest to have so much power and concentrated wealth in the hands of so few so that they can destabilize our entire economy.

Banking and Antitrust Laws Have Failed to Prevent Undue Concentration

Together with my colleagues I have spent the past 25 years warning policy makers of the systemic risk that was being created in our nation by the unbridled growth of the nation's largest banks and financial firms. But, I was told that I didn't get it, that I didn't understand the new global economy, that I was a protectionist, that I was afraid of competition, and that I needed to get with the "modern" times.

Sadly, we now know what modern times look like and it isn't pretty. Our financial system is imploding around us. Why is this the case, and why must Congress take bold action?

One important reason is that banking and antitrust laws fail to address the systemic risks posed by excessive financial concentration. Their focus is too narrow. Antitrust laws are designed to maintain competitive geographic and product markets. So long as the courts and agencies can discern that there are enough competitors in a particular market, that is the end of the inquiry.

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[3] March 8, 2009

[4] "Financial Reform; A Framework for Financial Stability, January 15, 2009, p. 8.

This type of analysis often prevents local banks from merging. But, it has done nothing to prevent the creation of giant nationwide franchises competing with each other in various local markets. No one asked, is the nation's banking industry becoming too concentrated and are individual firms becoming too powerful, both economically and politically.

The banking laws are also subject to misguided tunnel vision. The question is always whether a given merger will enhance the safety and soundness of an individual firm. The answer has been that "bigger" is almost necessarily "stronger." A bigger firm can – many said – spread its risk across geographic areas and business lines. No one wondered what would happen if one firm, or a group of firms, decides to jump off a cliff as they did in the subprime mortgage market. Now we know.

It is time for Congress to change these laws and direct that the nation's regulatory system take systemic risk into account and take steps to reduce and eventually eliminate it.

State of Community Banking is Strong

Despite the challenges we face, the community bank segment of the financial system is still working and working well. We are open for business, we are making loans, and we are ready to help all Americans weather these difficult times.

Community banks are strong, commonsense lenders that largely did not engage in the practices that led to the current crisis. Most community banks take the prudent approach of providing loans that customers can repay, which best serves both banks and customers. As a result of this commonsense approach to banking, the community banking industry, in general, is well-capitalized and has fewer problem assets than other segments of the financial services industry.

That is not to suggest that community banks are unaffected by the recent financial collapse. The general decline in the economy has caused many consumers to tighten their belts and reduce the demand for credit. Commercial real estate markets in some areas are stressed. Many bank examiners are overreacting, sending a message that contradicts recommendations from Washington that banks maintain and increase lending. That is why it is essential that the government continue its efforts to stabilize the financial system.

But, Congress must recognize that these efforts are blatantly unfair. Almost every Monday morning for months community banks have woken up to news that the government has bailed out yet another too-big-to-fail institution. On many Saturdays they hear that the FDIC has summarily closed one or two too-small-to-save institutions. And, just recently, the FDIC proposed a huge special premium to shore up the Deposit Insurance Fund to pay for losses imposed by large

institutions. This inequity must end, and only Congress can do it. The current situation – if left uncorrected – will damage community banks and the consumers and small businesses that we serve.

Maintain a Diversified Financial Regulatory System

While ICBA strongly supports creation of an effective systemic risk regulator, we oppose the establishment of a single, monolithic regulator for the financial system. Having more than a single federal agency regulating depository institutions provides valuable regulatory checks-and-balances and promotes "best practices" among those agencies – much like having multiple branches of government. The collaboration that is required by multiple federal agencies on each interagency regulation insures that all perspectives and interests are represented, that no one type of institution will benefit over another, and that the resulting regulatory or supervisory product is superior.

A monolithic federal regulator such as the U.K.'s Financial Service Authority would be dangerous and unwise in a country with a financial services sector as diverse as the United States, with tens of thousands of banks and other financial services providers. Efficiency must be balanced against good public policy. With the enormous power of bank regulators and the critical role of banks in the health and vitality of the national economy, it is imperative that the bank regulatory system preserves real choice, and preserves both state and federal regulation.

For over three generations, the U.S. banking regulatory structure has served this nation well. Our banking sector was the envy of the world and the strongest and most resilient financial system ever created. But we have gotten off the track. Non-bank financial regulation has been lax and our system has allowed – and even encouraged – the establishment of financial institutions that are too big to manage, too big to regulate, and too big to fail.

Congress need not waste time rearranging the regulatory boxes to change the system of community bank regulation. That system has worked, is working, and will work in the future. The failure occurred in the too-big-to-fail sector. That is the sector Congress must fix.

Identification and Regulation of Systemic Risk Institutions

ICBA recommends that Congress establish an interagency task force to identify institutions that pose a systemic financial risk. At a minimum, this task force should include the agencies that regulate and supervise FDIC-insured banks – including the Federal Reserve – plus the Treasury and Securities and Exchange Commission. This task force would be fully staffed by individuals from those agencies, and should be charged with identifying specific institutions that pose a systemic risk. The task force should be directed by an individual appointed by the President and confirmed by the Senate.

Once the task force has identified systemic risk institutions, they should be referred to the systemic risk regulator. Chairman Bernanke's March 10th speech provides a good description of the systemic risk regulator's duties: "Any firm whose failure would pose a systemic risk must receive especially close supervisory oversight of its risk-taking, risk management, and financial condition, and be held to high capital and liquidity standards." Bernanke continued: "The consolidated supervisors must have clear authority to monitor and address safety and soundness concerns in all parts of the organization, not just the holding company."

Of course, capital is the first line of defense against losses. Community banks have known this all along and generally maintained higher than required levels. This practice has helped many of our colleagues to weather the current storm. The new systemic risk regulator should adopt this same philosophy for the too-big-to-fail institutions that it regulators.

Clearly, the systemic risk regulator should also have the authority to step in and order the institution to cease activities that impose a systemic risk. Many observers warned that many players in the nation's mortgage market were taking too many risks. Unfortunately, no one agency attempted to step in and stop imprudent lending practices across the board. An effective systemic risk regulator must have the unambiguous duty and authority to block any financial activity that threatens to impose a systemic risk.

Assessment of Systemic Risk Regulatory Fees

The identification, regulation, and supervision of these institutions will impose significant costs on the systemic risk task force and systemic risk regulator. Systemic risk institutions must be assessed the full costs of these government expenses. This would entail a fee, similar to the examination fees banks must pay to their chartering agencies.

Resolving Systemic Risk Institutions

Chairman Bair and Chairman Bernanke have each recommended that the United States develop a mechanism for resolving systemic risk institutions. This is essential to avoid a repeat of the series of the ad hoc weekend bailouts that have proven so costly and infuriating to the public and unfair to institutions that are too small to save.

Again, Bernanke's March 10th speech outlined some key considerations:

> The new resolution regime would need to be carefully crafted. For example, clear guidelines must define which firms could be subject to the alternative regime and the process for invoking that regime, analogous perhaps to the procedures for invoking the so-called systemic risk exception under the FDIA. In addition, given the global operations of many large and complex financial firms and the complex

> regulatory structures under which they operate, any new regime must be structured to work as seamlessly as possible with other domestic or foreign insolvency regimes that might apply to one or more parts of the consolidated organization.

This resolution process will, obviously, be expensive. Therefore, Congress should direct the systemic risk regulator to establish a fund to bear these costs. The FDIC provides a good model. Congress has designated a minimum reserve ratio for the FDIC's Deposit Insurance Fund and directed the agency to assess risk-based premiums to maintain that ratio. Instead of deposits, the ratio for the systemic risk fund should apply as broadly as possible to ensure that all the risks that are covered are assessed.

Some of the systemic risk institutions will certainly include FDIC-insured banks within their holding companies. These banks would certainly not be resolved in the same way as a stand-alone community bank; all depositors would be protected beyond the statutory limits. Therefore, the Congress should direct the FDIC to impose a systemic risk fee on these institutions in addition to their regular premiums.

Last week's news that AIG was required by contract to pay hundreds of millions of dollars in bonuses to the very people that ruined that company point to another requirement for an effective systemic risk regulator. Once a systemic risk institution becomes a candidate for open-institution assistance or resolution, the regulator should have the same authority to abrogate contracts as the FDIC when it is appointed conservator and receiver of a bank. If the executives and other high-paid employees of these institutions understood that they could not design employment contracts that harmed the public interest, their willingness to take unjustified risk might diminish.

Breaking up Systemic Risk Institutions & Preventing Establishing New Threats

ICBA believes that imposing systemic risk regulation and imposing systemic risk fees and premiums will provide incentives to firms to voluntarily divest activities or not become too big to fail. However, these incentives may not be adequate. Therefore, Congress should direct the systemic risk task force to order the break up of systemic risk institutions over a five year period. These steps will reverse the long-standing regulatory policy that has favored the creation of ever-larger financial institutions.

ICBA understands that this will be a controversial recommendation, and many firms will object. Let me be clear. We do not advocate liquidation of ongoing, profitable activities. Huge conglomerate holding companies should be separated into business units that make sense. This could be done on the basis of business lines or geographical divisions. Parts of larger institutions could be sold

to other institutions. The goal is to reduce systemic risk, not to reduce jobs or service to consumers and businesses.

Maintain and Strengthen the Separation of Banking and Commerce

Congress has consistently followed one policy that has prevented the creation of some systemic risk institutions. The long-standing policy prohibiting affiliations or combinations between banks and non-financial commercial firms (such as Wal-Mart and Home Depot) has served our nation well. ICBA opposes any regulatory restructuring that would allow commercial entities to own a bank. If it is generally agreed that the current financial crisis is the worst crisis to strike the United States since the Great Depression, how much worse would this crisis have been had the retail commercial sector been intertwined as well? Regulators are unable to properly regulate the existing mega financial firms, how much worse would it be to attempt to regulate business combinations many times larger than those that exist today?

This issue has become more prominent with recent Federal Reserve encouragement of greater equity investments by commercial companies in financial firms. This is a very dangerous path.

Mixing banking and commerce is bad public policy because it creates conflicts of interest, skews credit decisions, and produces dangerous concentrations of economic power. It raises serious safety and soundness concerns because the companies operate outside the consolidated supervisory framework Congress established for owners of insured banks. It exposes the bank to risks not normally associated with banking. And it extends the FDIC safety net putting taxpayers at greater risk. Mixing banking and commerce was at the core of a prolonged and painful recession in Japan.

Congress has voted on numerous occasions to close loopholes that permitted the mixing of banking and commerce, including the non-bank bank loophole in 1987 and the unitary thrift holding company loophole in 1999. However, the Industrial Loan Company loophole remains open.

ICBA greatly appreciates the leadership of both Chairman Frank and Ranking Member Bachus to close this loophole, a goal ICBA continues to pursue. Creating greater opportunities to widen this loophole would be a serious public policy mistake, potentially depriving local communities of capital, local ownership, and civic leadership.

Conclusion

ICBA greatly appreciates this opportunity to testify. We recommend that Congress take a number of steps to regulate, assess, and ultimately break up institutions that pose unacceptable risks to the nation's financial system. At the

same time, Congress should avoid doing damage to the regulatory system for community banks, a system that has been tremendously effective. Finally, Congress should prevent the unwise concentration of financial and commercial power that would result if commercial firms like Wal-Mart could combine with federally insured banks.

The current crisis provides you an opportunity to strengthen our nation's financial system and economy by taking these important steps. ICBA urges Congress to quickly seize that opportunity.

Consumer Federation of America

Testimony of Travis Plunkett
Legislative Director
Consumer Federation of America

Hearing on "Systemic Risk"

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

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Mr. Chairman and Members of the Committee, my name is Travis Plunkett. I am Legislative Director of the Consumer Federation of America (CFA). CFA is a non-profit association of 280 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy, and education.

I greatly appreciate the opportunity to appear before you today to testify about one of the most important issues Congress will need to address as it develops a comprehensive agenda to reform our nation's failed financial regulatory system – how to better protect the system as a whole and the broader economy from systemic risks. Recent experience has shown us that our current system was not up to the task, either of identifying significant risks, or of addressing those risks before they spun out of control, or of dealing efficiently and effectively with the situation once it reached crisis proportions. The effects of this failure on the markets and the economy have been devastating, rendering reform efforts aimed at protecting the system against systemic threats a top priority.

In order to design an effective regulatory response, it is necessary to understand why the system failed. It has been repeated so often in recent months that it has taken on the aura of gospel, but it is simply not the case that the systemic risks that have threatened the global financial markets and ushered in the most serious economic crisis since the Great Depression arose because regulators lacked either sufficient information or the tools necessary to protect the financial system as a whole against systemic risks. (Though it is true that, once the crisis struck, regulators lacked the tools needed to deal with it effectively.) On the contrary, the crisis resulted from regulators' refusal to heed overwhelming evidence and repeated warnings about growing threats to the system.

- Former Congressman Jim Leach and former CFTC Chairwoman Brooksley Born both identified the potential for systemic risk in the unregulated over-the-counter derivatives markets in the 1990s.

- Housing advocates have been warning the Federal Reserve since at least the early years of this decade that securitization had fundamentally changed the underwriting standards for mortgage lending, that the subprime mortgages being written in increasing numbers were unsustainable, that foreclosures were on the rise, and that this had the potential to create systemic risks.

- The SEC's risk examination of Bear Stearns had, according to the agency's Inspector General, identified several of the risks in that company's balance sheet, including its use of excessive leverage and an over-concentration in mortgage-backed securities.

Contrary to conventional wisdom, these examples and others like them provide clear and compelling evidence that, in the key areas that contributed to the current crisis – unsound mortgage lending, the explosive combination of risky assets and excessive leverage on financial institutions' balance sheets, and the growth of an unregulated "shadow" banking system – regulators had all the information they needed to identify the crucial risks that threatened our financial system but either didn't use the authority they had or, in Born's case, were denied the authority they needed to rein in those risks.

Regulatory intervention at any of those key points had the potential to prevent, or at least greatly reduce the severity of, the current financial crisis – either by preventing the unsound

mortgages from being written that triggered the crisis, or by preventing investment banks and other financial institutions from taking on excessive leverage and loading up their balance sheet with risky assets, leaving them vulnerable to failure when the housing bubble burst, or by preventing complex networks of counterparty risk to develop among financial institutions that allowed the failure of one institution to threaten the failure of the system as a whole. This view is well-articulated in the report of the Congressional Oversight Panel, which correctly identifies a fundamental abandonment of traditional regulatory principles as the root cause of the current financial crisis and prescribes an appropriately comprehensive response.

So what is the lesson to be learned from that experience for Congress's current efforts to enhance systemic risk regulation? The lesson is emphatically not that there is no need to improve systemic risk regulation. On the contrary, this should be among the top priorities for financial regulatory reform. But there is a cautionary lesson here about the limitations inherent in trying to address problems of inadequate systemic risk regulation with a structural solution. In each of the above examples, and others like them, the key problem was not insufficient information or inadequate authority; it was an unwillingness on the part of regulators to use the authority they had to rein in risky practices. That lack of regulatory will had its roots in an irrational faith among members of both political parties in markets' ability to self-correct and industry's ability to self-police.

Until we abandon that failed regulatory philosophy and adopt in its place an approach to regulation that puts its faith in the ability and responsibility of government to serve as a check on industry excesses, whatever we do on systemic risk is likely to have little effect. Without that change in governing philosophy, we will simply end up with systemic risk regulation that exhibits the same unquestioning, market-fundamentalist approach that has characterized substantive financial regulation to a greater or lesser degree for the past three decades.

If the "negative" lesson from recent experience is that structural solutions to systemic risk regulation will have limited utility without a fundamental change in regulatory philosophy, there is also a positive corollary. Simply closing the loopholes in the current regulatory structure, reinvigorating federal regulators, and doing an effective job at the day-to-day tasks of routine safety and soundness and investor and consumer protection regulation would go a long way toward eliminating the greatest threats to the financial system.

The "Shadow" Banking System Represents the Greatest Systemic Threat

In keeping with that notion, the single most significant step Congress could and should take right now to decrease the potential for systemic risk is to shut down the shadow banking system completely and permanently. While important progress is apparently being made (however slowly) in moving credit default swaps onto a clearinghouse, this is just a start, and a meager start at that. Meaningful financial regulatory reform must require that all financial activities be conducted in the light of regulatory oversight according to basic rules of transparency, fair dealing, and accountability.

As Frank Partnoy argued comprehensively and persuasively in his 2003 book, *Infectious Greed,* a primary use of the "shadow" banking system – and indeed the main reason for its existence – is to allow financial institutions to do indirectly what they or their clients would not be permitted to do directly in the regulated markets. So banks used unregulated special purpose entities to hold toxic assets that, if held on their balance sheets, would have required them to set

aside additional capital, relying on the fiction that the bank itself was not exposed to the risks. Investment banks sold Mezzanine CDOs to pension funds in private placements free from disclosure and other obligations of the regulated marketplace. And everyone convinced themselves that they were protected from the risks of those toxic assets because they had insured them using credit default swaps sold in the over-the-counter market without the basic protections that trading on an exchange would provide, let alone the reserve or collateral requirements that would, in the regulated insurance market, provide some assurance that any claims would be paid.

The basic justification for allowing two systems to grow up side-by-side – one regulated and one not – is that sophisticated investors are capable of protecting their own interests and do not require the basic protections of the regulated market. That myth has been dispelled by the current crisis. Not only did "sophisticated" institutional investors load up on toxic mortgage-backed securities and collateralized debt obligations without understanding the risks of those investments, but financial institutions themselves either didn't understand or chose to ignore the risks they were exposing themselves to when they bought toxic assets with borrowed money or funded long-term obligations with short-term financing. By failing to protect their own interests, they damaged not only themselves and their shareholders, but also the financial markets and the global economy as a whole. This situation simply cannot be allowed to continue. Any proposal to address systemic risk must confront this issue head-on in order to be credible.

Other Risk-Related Priorities Should Also Be Addressed

There are other pressing regulatory issues that, while not expressly classified as systemic risk, are directly relevant to any discussion of how best to reduce systemic risk. Chairman Frank has appropriately raised the issue of executive compensation in this context, and CFA supports efforts to reduce compensation incentives that promote excessive risk-taking.

Similarly, improving the reliability of credit ratings while simultaneously reducing our reliance on those ratings is a necessary component of any comprehensive plan to reduce systemic risk. Ideally, some mechanism will be found to reduce the conflicts of interest associated with the agencies' issuer-paid compensation model. Whether or not that is the case, we believe credit rating agencies must face increased accountability for their ratings, the SEC must have increased authority to police their ratings activities to ensure that they follow appropriate due diligence standards in arriving at and maintaining those ratings, and laws and rules that reference the ratings must make clear that reliance on ratings alone does not satisfy due diligence obligations to ensure the appropriateness of the investment.

In addition, CFA believes one of the most important lessons that have been learned regarding the collapse of our financial system is that improved, up-front product-focused regulation will significantly reduce systemic risk. For example, if federal regulators had acted more quickly to prevent abusive sub-prime mortgage loans from flooding the market, it is likely that the current housing and economic crisis would not have been triggered. As a result, we have endorsed the concept advanced by COP Chair Elizabeth Warren and legislation introduced by Senator Richard Durbin and Representative William Delahunt to create an independent financial safety commission to ensure that financial products meet basic standards of consumer protection. Some opponents of this proposal have argued that it would stifle innovation. However, given the damage that recent "innovations" such as liar's loans and Mezzanine CDOs have done to the global economy, this hardly seems like a compelling argument. By distinguishing between

beneficial and harmful innovations, such an approach could in our view play a key role in reducing systemic risks.

Congress Needs To Enhance the Quality of Systemic Risk Oversight

In addition to addressing those issues that currently create a significant potential for systemic risk, Congress also needs to enhance the quality of systemic risk oversight going forward. Financial Services Roundtable Chief Executive and CEO Steve Bartlett summed up the problem well in earlier testimony before the Senate Banking Committee when he said that the recent crisis had revealed that our regulatory system "does not provide for sufficient coordination and cooperation among regulators, and that it does not adequately monitor the potential for market failures, high-risk activities, or vulnerable interconnections between firms and markets that can create systemic risk."

In keeping with that diagnosis of the problem, CFA believes the goals of systemic risk regulation should be: 1) to ensure that risks that could threaten the broader financial system are identified and addressed; 2) to reduce the likelihood that a "systemically significant" institution will fail; 3) to strengthen the ability of regulators to take corrective actions before a crisis to prevent imminent failure; and 4) to provide for the orderly failure of non-bank financial institutions. The latter point deserves emphasis, because this appears to be a common misconception: the goal of systemic risk regulation is not to protect certain "systemically significant" institutions from failure, but rather to simultaneously reduce the likelihood of such a failure and ensure that, should it occur, there is a mechanism in place to allow that to happen with the minimum possible disruption to the broader financial markets.

Although there appears to be near universal agreement about the need to improve systemic risk regulation, strong disagreements remain over the best way to accomplish that goal. The remainder of this testimony will address those key questions regarding such issues as who should regulate for systemic risk, who should be regulated, what that regulation should consist of, and how it should be funded. CFA has not yet reached firm conclusions on all of these issues, including on the central question of how systemic risk regulation should be structured. Where our position remains unresolved, we will discuss possible alternatives and the key issues we believe need to be resolved in order to arrive at a conclusion.

Should there be a central systemic risk regulator?

As discussed above, we believe all financial regulators should bear a responsibility to monitor for and mitigate potential systemic risks. Moreover, we believe a regulatory approach that both closes regulatory loopholes and reinvigorates traditional regulation for solvency and consumer and investor protection would go a long way toward accomplishing that goal. Nonetheless, we agree with those who argue that there is a benefit to having some central authority responsible and accountable for overseeing these efforts, if only to coordinate regulatory efforts related to systemic risk and to ensure that this remains a priority once the current crisis is past.

Perhaps the best reason to have one central authority responsible for monitoring systemic risk is that, properly implemented, such an approach offers the best assurance that financial institutions will not be able to exploit newly created gaps in the regulatory structure. Financial institutions have devoted enormous energy and creativity over the past several decades to

finding, maintaining, and exploiting gaps in the regulatory structure. Even if Congress does all that we have urged to close the regulatory gaps that now exist, past experience suggests that financial institutions will immediately set out to find new ways to evade legal restrictions.

A central systemic risk regulatory authority could and should be given responsibility for quickly identifying any such activities and assigning them to their appropriate place within the regulatory system. Without such a central authority, regulators may miss activity that does not explicitly fall within their jurisdiction or disputes may arise over which regulator has authority to act. CFA believes designating a central authority responsible for systemic risk regulation offers the best hope of quickly identifying and addressing new risks that emerge that would otherwise be beyond the reach of existing regulations.

Who should it be?

Resolving who should regulate seems to be the most vexing problem in designing a system for improved systemic risk regulation. Three basic proposals have been put forward: 1) assign responsibility for systemic risk regulation to the Fed; 2) create a new market stability regulator; and 3) expand the President's Working Group on Financial Markets (PWG) and give it an explicit mandate to coordinate and oversee regulatory efforts to monitor and mitigate systemic threats. Each approach has its flaws, and it is far easier to poke holes in the various proposals than it is to design a fool-proof system for improving risk regulation.

The Federal Reserve Board – Many people believe the Federal Reserve Board (the "Fed") is the most logical body to serve as systemic risk overseer. Those who favor this approach argue that the Fed has the appropriate mission and expertise, an experienced staff, a long tradition of independence, and the necessary tools to serve in this capacity (e.g., the ability to act as lender of last resort and to provide emergency financial assistance during a financial crisis). Robert C. Pozen summed up this viewpoint succinctly when he testified before the Senate Committee on Homeland Security and Governmental Affairs. He said:

> "Congress should give this role to the Federal Reserve Board because it has the job of bailing out financial institutions whose failure would threaten the whole financial system … If the Federal Reserve Board is going to bail out a broad array of financial institutions, and not just banks, it should have the power to monitor systemic risks so it can help keep institutions from getting to the brink of failure."

Two other, more pragmatic arguments have been cited in favor of giving these responsibilities to the Fed: 1) its ability to obtain adequate resources without relying on the congressional budget process and 2) the relative speed and ease with which this expansion of authority could be accomplished, particularly in comparison with the challenges of establishing a new agency for this purpose.

Others are equally convinced that the Fed is the last agency that should be entrusted with responsibility for systemic risk regulation. Some cite concerns about conflicts inherent in the governance role bank holding companies play in the regional Federal Reserve Banks. Particularly when combined with the Board's closed culture and lack of public accountability, this conflict is seen as likely to undermine public trust in the objectivity of agency decisions about which institutions will be bailed out and which will be allowed to fail in a crisis. Opponents of the Fed as systemic risk regulator also cite a conflict between its role setting

monetary policy and its potential role as a systemic risk regulator. One concern is that its role in setting monetary policy requires freedom from political interference, while its role as systemic risk regulator would require full transparency and public accountability. Another involves the question of how the Fed as systemic risk regulator would deal with the Fed as central banker if its monetary policy was contributing to systemic risk (as it clearly did in the run-up to the current crisis).

Others simply point to what they see as the Fed's long history of regulatory failure. This includes not only failures directly related to the current crisis – its failure to address unsound mortgage lending on a timely basis, for example, as well as its failure to prevent banks from holding risky assets in off-balance-sheet special purpose entities and its cheerleading of the rapid expansion of the shadow banking system – but also a perceived past willingness at the Fed to allow banks to hide their losses. According to this argument, Congress ultimately passed FDICIA in 1991 (requiring regulators to close financial institutions before all the capital or equity has been depleted) precisely because the Fed had been unwilling to do so absent that requirement.

Should Congress determine to give systemic risk responsibility to the Fed, we believe it is essential that you take meaningful steps to address what we believe are compelling concerns about this approach. Even some who have spoken in favor of the Fed in this capacity have acknowledged that it will require significant restructuring. As former Federal Reserve Chairman Paul Volcker noted in remarks before the Economic Club of New York last April:

> "If the Federal Reserve is also … to have clear authority to carry effective 'umbrella' oversight of the financial system, internal reorganization will be essential. Fostering the safety and stability of the financial system would be a heavy responsibility paralleling that of monetary policy itself. Providing direction and continuity will require clear lines of accountability …, all backed by a stronger, larger, highly experienced and reasonably compensated professional staff."

CFA concurs that, if systemic risk regulation is to be housed at the Fed, systemic risk regulation must not be relegated to Cinderella status within the agency. Rather, it must be given a high priority within the organization, and significant additional staff dedicated to this task must be hired who have specific risk assessment expertise. Serious thought must also be given to 1) how to resolve disputes between these two potentially competing functions of setting monetary policy and mitigating systemic risks, and 2) how to ensure that systemic risk regulation is carried out with the full transparency and public accountability that it demands.

A New Systemic Risk Regulatory Agency – Some have advocated creation of an entirely new regulatory agency devoted to systemic risk regulation. The idea behind this approach is that it would allow a singular focus on issues of systemic risk, both providing clear accountability and allowing the hiring of specialized staff devoted to this task. Furthermore, such an agency could be structured to avoid the significant concerns associated with designating the Fed to perform this function, including the conflict between monetary policy and systemic risk regulation.

Although it has its advocates, this approach appears to trigger neither the broad support nor the impassioned opposition that the Fed proposal engenders. Those who favor this approach, including Brookings scholar Robert Litan, tend to do so only if it is part of a more radical

regulatory restructuring. Adding such an agency to the existing regulatory structure would "add still another cook to the regulatory kitchen, one that is already too crowded, and thus aggravate current jurisdictional frictions," Litan said in recent testimony before the Senate Committee on Homeland Security and Governmental Operations. Moreover, even its advocates tend to acknowledge that it would be a challenge, and possibly an insurmountable challenge, to get such an agency up and running in a timely fashion.

Expanded and Refocused President's Working Group – The other approach that enjoys significant support entails giving an expanded version of the President's Working Group for Financial Markets clear, statutory authority for systemic risk oversight. Its current membership would be expanded to include all the major federal financial regulators as well as representatives of state securities, insurance, and banking officials. By formalizing the PWG's authority through legislation, the group would be directly accountable to Congress, allowing for meaningful congressional oversight.

Among the key benefits of this approach: the council would have access to extensive information about and expertise in all aspects of financial markets. The regulatory bodies with primary day-to-day oversight responsibility would have a direct stake in the panel and its activities, maximizing the chance that they would be fully cooperative with its efforts. For those who believe the Fed must play a significant role in systemic risk regulation, this approach offers the benefit of extensive Fed involvement as a member of the PWG without the problems associated with exclusive Fed oversight of systemic risk.

This approach, while offering attractive benefits, is not without its short-comings. One is the absence of any single party who is solely accountable for regulatory efforts to mitigate systemic risks. Because it would have to act primarily through its member bodies, it could result in an inconsistent and even conflicting approach among regulators. It also raises the risk that systemic risk regulation will not be given adequate priority. In dismissing this approach, Litan acknowledges that it may be the most politically feasible but he maintains: "A college of regulators clearly violates the Buck Stops Here principle, and is a clear recipe for jurisdictional battles and after-the-fact finger pointing."

Despite the many attractions of this approach, this latter point is particularly compelling, in our view. Regulators have a long history of jurisdictional disputes. There is no reason to believe those problems would simply dissipate under this arrangement. Decisions about who has responsibility for newly emerging activities would likely be particularly contentious. If Congress were to decide to adopt this approach, it would need to set out some clear mechanism for resolving any such disputes. Alternatively, it could combine this approach with enhanced systemic risk authority for either the Fed or a new agency, as the Financial Services Roundtable has suggested, providing that agency with the benefit of the panel's broad expertise and improving coordination of regulatory efforts in this area.

FDIC – A major reason federal authorities were forced to improvise in managing the events of the past year is that we lack a mechanism for the orderly unwinding of non-bank financial institutions that is comparable to the authority that the FDIC has for banks. Most systemic risk plans seem to contemplate expanding FDIC authority to include non-bank financial institutions, although some would house this authority within a systemic risk regulator. CFA believes this is an essential component of a comprehensive plan for enhanced systemic risk regulation. While we have not worked out exactly how this should operate, we believe the

FDIC, the systemic risk regulator, or the two agencies working together must also have authority to intervene when failure appears imminent to require corrective actions.

A Systemic Risk Advisory Panel – One of the key criticisms of making the Fed the systemic risk regulator is its dismal regulatory record. But if we limited our selections to those regulators with a credible record of identifying and addressing potential systemic risks while they are still at a manageable stage, we'd be forced to start from scratch in designing a new regulatory body. And there is no guarantee we would get it right this time.

A number of academics and others outside the regulatory system were far ahead of the regulators in recognizing the risks associated with unsound mortgage lending, unreliable ratings on mortgage-backed securities and CDOs, the build-up of excessive leverage, the questionable risk management practices of investment banks, etc. Regardless of what approach Congress chooses to adopt for systemic risk oversight, we believe it should also mandate creation of a high-level advisory panel on systemic risk. Such a panel could include academics and other analysts from a variety of disciplines with a reputation for independent thinking and, preferably, a record of identifying weaknesses in the financial system. Names such as Nouriel Roubini, Frank Partnoy, Joseph Mason, and Joshua Rosner immediately come to mind as attractive candidates for such a panel.

The panel would be charged with conducting an on-going and independent assessment of systemic risks to supplement the efforts of the regulators. It would report periodically to both Congress and the regulatory agencies on its findings. It could be given privileged access to information gathered by the regulators to use in making its assessment. When appropriate, it might recommend either legislative or regulatory changes with a goal of reducing risks to the financial system. CFA believes such an approach would greatly enhance the accountability of regulators and reduce the risks of group-think and complacency. We urge you to include this as a component of your regulatory reform plan.

Who should be regulated?

The debate over who should be regulated for systemic risk basically boils down to two main points of view. Those who see systemic risk regulation as something that kicks in during or on the brink of a crisis, to deal with the potential failure of one or more financial institutions, tend to favor a narrower approach focused on a few large or otherwise "systemically important" institutions. In contrast, those who see systemic risk regulation as something that is designed, first and foremost, to prevent risks from reaching that degree of severity tend to favor a much more expansive approach. Recognizing that systemic risk can derive from a variety of different practices, proponents of this view argue that all forms of financial activity must be subject to systemic risk regulation and that the systemic risk regulator must have significant flexibility and authority to determine the extent of its reach.

CFA falls firmly into the latter camp. We are not alone; this expansive view of systemic risk jurisdiction has many supporters, at least when it comes to the regulator's authority to monitor the markets for systemic risk. The Government Accountability Office, for example, has said that such efforts "should cover all activities that pose risks or are otherwise important to meeting regulatory goals." Bartlett of the Financial Services Roundtable summed it up well in his testimony when he said that:

> "... authority to collect information should apply not only to depository institutions, but also to all types of financial services firms, including broker/dealers, insurance companies, hedge funds, private equity firms, industrial loan companies, credit unions, and any other financial services firms that facilitate financial flows (e.g., transactions, savings, investments, credit, and financial protection) in our economy. Also, this authority should not be based upon the size of an institution. It is possible that a number of smaller institutions could be engaged in activities that collectively pose a systemic risk."

The case for giving a systemic risk regulator broad authority to monitor the markets for systemic risk is obvious, in our opinion. Failure to grant a regulator this broad authority risks allowing risks to grow up outside the clear jurisdiction of functional regulators, a situation financial institutions have shown themselves to be very creative at exploiting.

While the case for allowing the systemic risk regulator broad authority to monitor the financial system as a whole seems obvious, the issue of whether to also grant that regulator authority to constrain risky conduct wherever they find it is more complex. Those who favor a narrower approach argue that the proper focus of any such regulatory authority should be limited to those institutions whose failure would be likely to create a systemic risk. This view is based on the sentiment that, if an institution is too big to fail, it must be regulated. While CFA shares the view that those firms that are "too big to fail" must be regulated, we take that view one step further. As we have discussed above, we believe that the best way to reduce systemic risk is to ensure that all financial activity is regulated to ensure that it is conducted according to basic principles of transparency, fair dealing, and accountability.

Those like Litan who favor a narrower approach focused on "systemically important" institutions defend it against charges that it creates unacceptable moral hazard by arguing that it is essentially impossible to expand on the moral hazard that has already been created by recent federal bailouts simply by formally designating certain institutions as systemically significant. We agree that, based on recent events and unless the approach to systemic risk is changed, the market will assume that large firms will be rescued, just as the market rightly assumed for years, despite assurances to the contrary, that the government would stand behind the GSEs. Nonetheless, we do not believe it follows that the appropriate approach to systemic risk regulation is to focus exclusively on these institutions that are most likely to receive a bailout. Instead, we believe it is essential to attack risks more broadly, before institutions are threatened with failure and, to the degree possible, to eliminate the perception that large institutions will always be rescued. The latter goal could be addressed both by reducing the practices that make institutions systemically significant and by creating a mechanism to allow their orderly failure.

Ultimately, we believe a regulatory approach that relies on identifying institutions in advance that are systemically significant is simply unworkable. The fallibility of this approach was demonstrated conclusively in the wake of the government's determination that Lehman Brothers, unlike Bear Stearns, was not too big to fail. As Richard Baker, President and CEO of the Managed Funds Association, said in his testimony before the House Capital Markets Subcommittee, "There likely are entities that would be deemed systemically relevant ... whose failure would not threaten the broader financial system." We also agree with NAIC Chief Executive Officer Therese Vaughn, who said in testimony at the same hearing, "In our view, an entity poses systemic risk when that entity's activities have the ability to ripple through the

broader financial system and trigger problems for other counterparties, such that extraordinary action is necessary to mitigate it."

The factors that might make an institution systemically important are complex – going well beyond asset size and even degree of leverage to include such considerations as nature and degree of interconnectivity to other financial institutions, risks of activities engaged in, nature of compensation practices, and degree of concentration of financial assets and activities, to name just a few. Trying to determine in advance where that risk is likely to arise would be all but impossible. And trying to maintain an accurate list of systemically important institutions going forward, considering the complex array of factors that are relevant to that determination, would require constant and detailed monitoring of institutions on the borderline, would be extremely time-consuming, and ultimately would almost certainly allow certain risky institutions and practices to fall through the cracks.

How should they regulate?

There are three key issues that must be addressed in determining the appropriate procedures for regulating to mitigate systemic risk:

- Should responsibility and authority to regulate for systemic risks kick in only in a crisis, or on the brink of a crisis, or should it be an on-going, day-to-day obligation of financial regulators?

- What regulatory tools should be available to a systemic risk regulator? For example, should a designated systemic risk regulator have authority to take corrective actions, or should it be required (or encouraged) to work through functional regulators?

- If a designated systemic risk regulator has authority to require corrective actions, should it apply generally to all financial institutions, products, and practices or should it be limited to a select population of systemically important institutions?

When the Treasury Department issued its Blueprint for regulatory reform a year ago, it proposed to give the Federal Reserve broad new authority to regulate systemic risk but only in a crisis. Despite the sweeping scope of its restructuring proposals, Treasury clearly envisioned a strictly limited role within systemic risk regulation for regulatory interventions exercised primarily through its role as lender of last resort. Although there are a few who continue to advocate a version of that viewpoint, we believe events since the Blueprint's release have conclusively proven the disadvantages of this approach. As Volcker stated in his New York Economic Club speech: "I do not see how that responsibility can be turned on only at times of turmoil – in effect when the horse has left the barn." We share that skepticism, convinced like the authors of the COP Report that, "Systemic risk needs to be managed before moments of crisis, by regulators who have clear authority and the proper tools."

As noted above, most parties appear to agree that a systemic risk regulator must have broad authority to survey all areas of financial markets and the flexibility to respond to emerging areas of potential risk. CFA shares this view, believing it would be both impractical and dangerous to require the regulator to go back to Congress each time it sought to extend its jurisdiction in response to changing market conditions. Others have described a robust set of additional tools that regulators should have to minimize systemic risks. As the Group of 30

noted in its report on regulatory reform: "... a legal regime should be established to provide regulators with authority to require early warnings, prompt corrective actions, and orderly closings" of certain financial institutions. The specific regulatory powers various parties have recommended as part of a comprehensive framework for systemic risk regulation include authority to:

- Set capital, liquidity, and other regulatory requirements directly related to risk management;
- Require firms to pay some form of premium, much like the premiums banks pay to support the federal deposit insurance fund, adjusted to reflect the bank's size, leverage, and concentration, as well as the risks associated with its activities;
- Directly supervise at least certain institutions;
- Act as lender of last resort with regard to institutions at risk of failure;
- Act as a receiver or conservator of a failed non-depository organization and to place the organization in liquidation or take action to restore it to a sound and solvent condition;
- Require corrective actions at troubled institutions that are similar to those provided for in FDICIA;
- Make regular reports to Congress; and
- Take enforcement actions, with powers similar to what Federal Reserve currently has over bank holding companies.

Without evaluating each recommendation individually or in detail, CFA believes this presents an appropriately comprehensive view of the tools necessary for systemic risk regulation.

Most of those who have commented on this topic would give at least some of this responsibility and authority – such as demanding corrective actions to reduce risks – directly to a systemic risk regulator. Others would require in all but the most extreme circumstances that a systemic risk regulator exercise this authority only in cooperation with functional regulators. Both approaches have advantages and disadvantages. Giving a systemic risk regulator this authority would ensure consistent application of standards and establish a clear line of accountability for decision-making in this area. But it would also demand, perhaps unrealistically, that the regulator have a detailed understanding of how those standards would best be implemented in a vast variety of firms and situations. Relying on functional regulators to act avoids the latter problem but sets up a potential for jurisdictional conflicts as well as inconsistent and delayed implementation. If Congress decides to adopt the latter approach, it will need to make absolutely clear what authority the systemic risk regulator has to require its regulatory partners to take appropriate action. Without that clarification, disputes over jurisdiction are inevitable, and inconsistencies and conflicts are bound to emerge. It would also be doubly important under such an approach to ensure that gaps in the regulatory framework are closed and that all regulators share a responsibility for reducing systemic risk.

Many of those who would give a systemic risk regulator this direct authority to demand corrective actions would limit its application to a select population of systemically important institutions. The Securities Industry and Financial Markets Association has advocated, for example, that the resolution system for non-bank firms apply only to "the few organizations whose failure might reasonably be considered to pose a threat to the financial system." In testimony before the House Capital Markets Subcommittee, SIFMA President and CEO T. Timothy Ryan, Jr. also suggested that the systemic risk regulator should only directly supervise systemically important financial institutions.

Such an approach requires a systemic risk regulator to identify in advance those institutions that pose a systemic risk. Others express strong opposition to this approach. As former Congressman Baker of the MFA said in his recent House subcommittee testimony:

> "An entity that is perceived by the market to have a government guarantee, whether explicit or implicit, has an unfair competitive advantage over other market participants. We strongly believe that the systemic risk regulator should implement its authority in a way that avoids this possibility and also avoids the moral hazards that can result from a company having an ongoing government guarantee against failure."

Unfortunately, the recent actions the government was called on to take to rescue a series of non-bank financial institutions has already created that implied backing. Simply refraining from designating certain institutions as systemically significant will not be sufficient to dispel that expectation, and it would at least provide the opportunity to subject those firms to tougher standards and enhanced oversight. As discussed above, however, CFA believes this approach to be unworkable.

That is a key reason why we believe it is absolutely essential to provide for corrective action and resolution authority as part of a comprehensive plan for enhanced systemic risk regulation. As money manager Jonathan Tiemann argued in a recent article entitled "The Wall Street Vortex":

> "Some institutions are so large that their failure would imperil the financial system. As such, they enjoy an implicit guarantee, which could … force us to nationalize their losses. But we need for all financial firms that run the risk of failure to be able to do so without causing a widespread financial meltdown. The most interesting part of the debate should be on this point, whether we could break these firms into smaller pieces, limit their activities, or find a way to compartmentalize the risks that their various business units take."

CFA believes this is an issue that deserves more attention than it has garnered to date. One option is to try to maximize the incentives of private parties to avoid risks, for example by subjecting financial institutions to risk-based capital requirements and premium payments. To serve as a significant deterrent to risk, these requirements would have to ratchet up dramatically as institutions grew in size, took on risky assets, increased their level of leverage, or engaged in other activities deemed risky by regulators. It has been suggested, for example, that the Fed could have prevented the rapid growth in use of over-the-counter credit default swaps by financial institutions if it had adopted this approach. It could, for example, have imposed capital standards for use of OTC derivatives that were higher than the margin requirements associated with trading the same types of derivatives on a clearinghouse and designed to reflect the added

risks associated with trading in the over-the-counter markets. In order to minimize the chances that institutions will avoid becoming too big or too inter-connected to fail, CFA urges you to include such incentives as a central component of your systemic risk regulation legislation.

Conclusion

Decades of Wall Street excess unchecked by reasonable and prudential regulation have left our markets vulnerable to systemic shock. The United States, and indeed the world, is still reeling from the effects of the latest and most severe of a long series of financial crises. Only a fundamental change in regulatory approach will turn this situation around. While structural changes are a part of that solution, they are by no means the most important aspect. Rather, returning to a regulatory approach that recognizes both the disastrous consequences of allowing markets to self-regulate and the necessity of strong and effective governmental controls to rein in excesses is absolutely essential to achieving this goal.

TESTIMONY OF
T. TIMOTHY RYAN, JR.
PRESIDENT AND CEO OF THE
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ON:

"PERSPECTIVES ON REGULATION OF SYSTEMIC RISK
IN THE FINANCIAL SERVICES INDUSTRY"

MARCH 17, 2009

I. Introduction

Chairman Frank, Ranking Member Bachus, members of the Committee:

My name is Tim Ryan and I am President and CEO of the Securities Industry and Financial Markets Association ("SIFMA").[1] Thank you for your invitation to testify at this important hearing. My testimony will detail SIFMA's views on a financial markets stability regulator, including the mission, purpose, powers and duties of such a regulator.

As we all know, financial markets across the globe have experienced severe dislocations in the last several months. Congress has aggressively responded to these challenges in the United States by passing sweeping

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

legislation, including the Emergency Economic Stabilization Act of 2008 (the "EESA"), the Housing and Economic Recovery Act of 2008, and the American Recovery and Reinvestment Act of 2009. Congress has rightly recognized, however, that addressing the immediate crisis is only half the battle. Improvements can be made to our current regulatory model for financial services which can help us avoid such crises in the future. We recognize that this is a moment in our history where such efforts are essential.

SIFMA stands ready to be a constructive voice in this critically important public policy dialogue to restore confidence in the global financial system. Our members understand the value that a well-designed and implemented regulatory system brings to minimizing systemic risk. We believe that a global effort is required to develop such a regulatory system with common principles that limit regulatory arbitrage between and among nations.

II. Financial Markets Stability Regulator

Systemic risk has been at the heart of the current financial crisis. While there is no single, commonly-accepted definition of systemic risk, we think of "systemic risk" as the risk of a systemwide financial crisis characterized by a significant risk of the contemporaneous failure of a substantial number of financial institutions or of financial institutions or a financial market controlling a significant amount of financial resources that could result in a severe contraction of credit in the U.S. or have other serious adverse effects on economic conditions or financial stability. SIFMA has devoted considerable time and resources to

thinking about systemic risk, and what can be done to identify it, minimize it, maintain financial stability and resolve a financial crisis in the future.

A regulatory reform committee of our members has met regularly in recent months to consider these issues, and to develop a workable proposal to address them. We have sponsored roundtable discussions with former regulators, financial regulatory lawyers and our members, as well as other experts, policymakers and stakeholders to develop solutions to the issues that have been exposed by the financial crisis and the challenges facing our financial regulatory architecture.

A. We Support the Proposal to Establish a Financial Markets Stability Regulator

Through this process, we have identified a number of questions and trade-offs that will confront policymakers in trying to mitigate systemic risk. There is an emerging consensus among our members that we need a financial markets stability regulator as a first step in addressing the challenges facing our overall financial regulatory structure. Other leading commentators have reached a similar conclusion. The G30, in its report on financial reform, supports a central body with the task of promoting and maintaining financial stability, and the Treasury, in its blueprint, also has supported a market stability regulator. More recently, Federal Reserve Chairman Ben Bernanke has identified the creation of a systemic risk authority as a key element of a strategy to reform the financial regulatory system.

We are realistic in what we believe a financial markets stability regulator can accomplish. Although the financial markets stability regulator may not be

able to identify the causes or prevent the occurrence of every financial crisis in the future, by ensuring that a single regulator has clear responsibility, broad aggregated information (across various financial institutions), and the supervisory tools needed to minimize these risks when identified, we believe this will substantially improve the current system. At present, no single regulator (or collection of coordinated regulators) has the authority or the resources to collect information system-wide or to use that information to take corrective action in a timely manner across all financial institutions and markets regardless of charter. The financial markets stability regulator will help fill these gaps.

B. Mission of the Financial Markets Stability Regulator

We believe that the mission of the financial markets stability regulator should consist of mitigating systemic risk, maintaining financial stability and addressing any financial crisis. Specifically, the financial markets stability regulator should have authority over all financial institutions and markets, regardless of charter, functional regulator or unregulated status. We agree with Chairman Bernanke that its mission should include monitoring systemic risks across firms and markets, rather than only at the level of individual firms or sectors; assessing the potential for practices or products to increase systemic risk; and identifying regulatory gaps that have systemic impact. One of the lessons learned from recent experience is that sectors of the market, such as the mortgage brokerage industry, can be systemically important, even though no single institution in that sector is a significant player. The financial markets stability regulator should have the authority to gather information from all financial

institutions and markets, adopt uniform regulations related to systemic risk, and act as a lender of last resort.

In carrying out its duties, the financial markets stability regulator should coordinate with the relevant functional regulators, as well as the President's Working Group, in order to avoid duplicative or conflicting regulation and supervision. It should also coordinate with regulators responsible for systemic risk in other countries. Although the financial markets stability regulator's role would be distinct from that of the functional regulators, it should have a more direct role in the oversight of systemically important financial organizations, including the power to conduct examinations, take prompt corrective action and appoint or act as the receiver or conservator of such systemically important groups. These more direct powers would end if a financial group were no longer systemically important.

We believe that all systemically important financial institutions that are not currently subject to federal functional regulation, such as insurance companies and hedge funds, should be subject to such regulation. But we do not believe the financial markets stability regulator should play that day-to-day role for those entities. The Investment Company Institute has suggested that hedge funds could be appropriately regulated by a merged SEC and CFTC. We agree with that viewpoint. The collapse of AIG has highlighted the importance of robust insurance holding company oversight. We believe the time has come for adoption of an optional federal insurance charter for insurance companies. We believe that a federal insurance regulator should be established to act as the federal functional

regulator of federally chartered insurance companies and possibly some state insurance companies, as well as the consolidated supervisor of insurance company holding companies that are not otherwise subject to federal consolidated supervision. We have also supported increasing the authority of the Municipal Securities Rulemaking Board to create a comprehensive regulatory framework for the municipal market that would extend to financial advisors, investment brokers and other intermediaries in the municipal market. On an ongoing basis, we believe the financial markets stability regulator should identify new players, products or sectors that are systemically important where there are gaps in the regulatory framework, and should be required to notify Congress of such deficiencies where further legislative action is necessary.

In a regulatory system where functional regulation is overlaid by financial stability oversight, how the financial markets stability regulator coordinates with the functional regulators is an important issue to consider. As a general principle, we believe the financial markets stability regulator should coordinate with the relevant federal functional regulators in order to avoid duplicative or conflicting regulation and supervision. For example, the financial markets stability regulator could be required to consult with functional regulators with regard to promulgating and enforcing systemic risk rules. The financial markets stability regulator might require enforcement authority, but should be required to coordinate the use of that authority with the relevant federal functional regulators.

However, in order for the financial markets stability regulator to provide oversight across institutions and markets, it may be necessary to impose an

obligation on functional regulators to share supervisory information with the financial markets stability regulator. Also, if federal functional regulators differ with respect to systemic risk issues, the financial markets stability regulator may need to take action to establish consistent rules with respect to systemic risk issues. And though the federal functional regulator would remain the primary regulator of any financial institution within a systemically important financial group, you might also consider whether the financial markets stability regulator should have the authority to override the federal functional regulator with respect to systemic risk issues.

C. Powers and Duties

There are many issues to consider in determining what the powers and duties should be of the financial markets stability regulator. We have identified and analyzed a number of them that we enumerate below.

1. Scope of Authority

The first issue to consider is the scope of authority of the new regulator. To be effective, the authority should probably extend to all financial institutions, markets, products and services. The new regulator should also probably have more direct supervisory power over systemically important financial institutions or groups.

You might want to consider defining certain kinds of institutions, markets, products or services as financial. Such categories should probably include currently unregulated financial institutions, such as hedge funds, private equity funds or others, in addition to regulated financial institutions, such as banks,

savings associations, other depository institutions, securities brokers or dealers, insurance companies, securities clearing agencies, derivatives clearing organizations, payment system operators, investment companies, investment advisers, commodity pool operators, commodity trading advisors or futures commission merchants. You might define markets broadly to include securities or futures markets, over-the-counter financial markets, electronic communications networks and alternative trading systems. You might also consider whether to give the financial markets stability regulator discretionary authority to declare other entities, markets, products or services to be financial or to exempt any financial institutions, markets, products or services from coverage, and what limits to put on those discretionary authorities.

You might also want to consider taking a similar approach to defining what constitutes a systemically important financial institution or group. Certain types of entities might be defined as systemically important, including primary dealers, securities clearing agencies, derivatives clearing organizations and payment system operators. You might also want to consider whether to give the financial markets stability regulator discretionary authority to declare any other financial institutions to be systemically important, and what limits to put on that authority. You might also want to consider whether the financial markets stability regulator should have discretionary authority to determine that an institution that was once designated as systemically important should no longer be classified that way if it is no longer systemically important.

2. Level Playing Field

In defining the powers and duties of the financial markets stability regulator, it will be important to maintain a level playing field between systemically important and other financial institutions. If systemically important financial groups are regulated more heavily than other financial institutions, this will perpetuate or create new opportunities for regulatory arbitrage. Any activities that are regulated more heavily when conducted by a systemically important institution will simply migrate to the relatively less regulated institutions or flow off-shore. Instead of reducing overall risk in the system, this approach would simply shift risk from one group to another. On the other hand, systemically important financial groups could be perceived to benefit from a "too big or too complex to fail" policy, which could result in a funding or other advantage over other financial institutions and an unacceptable level of moral hazard. Any legislation creating a financial markets stability regulator should try to be as neutral as possible between the two groups.

3. Information Gathering

You might consider giving the financial markets stability regulator the authority to gather information from all U.S. financial institutions and markets in order to identify systemic risk and maintain financial stability. You might also consider whether this authority should apply to all financial institutions, regardless of charter, and regardless of whether they are currently functionally regulated or not. The financial markets stability regulator will need information

necessary to form and maintain a picture of the overall systemic risks in the U.S. financial system.

4. Uniform Systemic Risk Rules

While some commentators have suggested that the regulatory powers of the financial markets stability regulator be focused exclusively on systemically important financial groups, we believe this would be a mistake. If the authority of the financial markets stability regulator is limited to systemically important financial groups, any efforts to identify and control systemic risk will simply result in shifting the risky activities to other financial institutions or off-shore rather than taking it out of the system or controlling it. Also, the financial markets stability regulator may identify sectors of the market where individual entities are not systemically important, but which entities in the aggregate can have a significant impact on systemic risk. You should therefore consider giving the financial markets stability regulator the authority to make uniform rules, where applicable, for any class of similarly situated financial institutions, markets, products or services to the extent necessary to reduce systemic risk and promote financial stability.

If you do, you should also consider whether to require the financial markets stability regulator to consult with the relevant federal functional regulators. The goal of such uniform systemic risk rules should not be to unduly burden smaller institutions that would be otherwise only be tangentially touched by the financial markets stability regulator. You might also consider giving a nonexclusive list of examples where the financial stability regulator has authority,

such as capital or liquidity rules for any class of similarly situated financial institutions, and risk management and transparency requirements.

5. Information Sharing

The financial markets stability regulator will need to coordinate with the relevant federal functional regulators in order to do its job properly. You should consider imposing an obligation on all functional regulators to share supervisory information with the financial markets stability regulator. It is difficult to see how the financial markets stability regulator will be able to do its job properly unless it has access to supervisory information gathered by all relevant functional regulators.

6. Confidential Supervisory Information

Some of the information gathered by the financial markets stability regulator, especially from otherwise unregulated financial institutions such as hedge funds or private equity funds, may not otherwise be publicly disclosed and may be confidential and proprietary. Such information should be treated as confidential supervisory information and therefore protected by statute against disclosure or loss of privilege, except to the extent it forms part of industry-wide data. Congress might consider reviewing the statutory protections of such information to determine whether they need to be strengthened. Otherwise, there could be legitimate and serious resistance to the financial stability regulator's information gathering powers from some financial institutions.

Similarly, all confidential supervisory information shared among federal regulators should have the same statutory protection. Such information should not

lose some or all of its protection because a functional regulator shares it with the financial markets stability regulator, or vice versa. You should consider reviewing the statutory protections governing confidential supervisory information to make sure they are all sufficiently protective.

7. Accountability

Given the scope of authority the financial markets stability regulator might have, it will be important to hold the financial markets stability regulator accountable for implementing its mission. The Congress should consider a robust reporting regime for the financial markets stability regulator including, at a minimum, annual reports to Congress. The financial markets stability regulator might report on (1) the risks to the U.S. financial system, (2) the regulatory measures being taken or that will be taken to address such risks, (3) the costs and benefits of such measures, (4) any adverse effects from such measures on market discipline, and (5) the steps being taken to minimize moral hazard and maximize the benefits of market discipline.

8. International Coordination

International coordination on systemic issues will be critical to avoid cross-border regulatory arbitrage. You should consider giving the financial markets stability a mandate to coordinate with any foreign or international body of regulators on systemic risk issues. The G30 report, for example, strongly encourages enhancing existing mechanisms for international regulatory and supervisory coordination.

9. Technology Platform

Because no U.S. regulator currently has the technology platform necessary to gather, aggregate and mine all the data that might be gathered by the financial markets stability regulator, you should consider giving the financial markets stability regulator a mandate to develop a plan to aggregate the data that currently resides at the different regulated industry utilities or otherwise build the systems necessary to achieve its goals.

10. Enforcement Authority

The financial markets stability regulator will not be able to carry out its mission effectively if it does not have the authority to enforce its rules or orders. Consequently, you should consider giving it enforcement authority similar to what the Federal Reserve has over bank holding companies, including the power to take formal and informal supervisory action against any financial institution or market. The financial markets stability regulator should generally be required to coordinate or defer to any relevant federal functional regulators in bringing enforcement action against any financial institution or market, other than a systemically important financial institution. But you should consider whether to give it override authority with respect to the enforcement of any rule, regulation or order made to reduce systemic risk or promote financial stability if it is not being adequately enforced by the relevant federal functional regulator.

11. Lender of Last Resort

Section 13(3) of the Federal Reserve Act has been the Federal Reserve's tool of choice in providing liquidity and other financial assistance to financial

institutions and the market during the current financial crisis. That has been its source of authority for its emergency liquidity facility to primary dealers, its rescue of AIG, the Commercial Paper Funding Facility, the Term Asset-Backed Securities Loan Facility (TALF), its credit support for Fannie and Freddie, its participation in the troubled asset guarantee programs, and most of its other emergency actions during the financial crisis. It would probably be useful to analyze whether Section 13(3) needs to be updated or modernized in any way in light of the lessons learned during the current financial crisis.

12. Consolidated Supervision and Examination Authority

The rest of the issues relate solely to systemically important financial institutions. The financial markets stability regulator is likely to argue that it requires direct consolidated supervisory authority over systemically important financial institutions in order to do its job effectively. You might therefore consider whether to give it the authority to be the consolidated supervisor of systemically important financial groups, much the way the Federal Reserve is currently the consolidated supervisor of bank holding company groups. You might also consider whether this authority should be exclusive at the group level. It may be unfair to subject a systemically important financial group to duplicative and overlapping consolidated supervision. This would not affect the functional regulation of any financial institution within the group, which would remain subject to functional regulation by its federal functional regulator. Although the financial markets stability regulator would ordinarily coordinate with or defer to the functional regulator of any financial institution within the group, you should

consider whether the financial markets stability regulator should have the authority to override any such functional regulator on systemic risk issues.

13. Prompt Corrective Action

The federal banking agencies currently have the authority to take a wide variety of correction actions well before an insured bank becomes insolvent. This gives the banking agencies the flexibility to address issues before they turn into a crisis. While having authority is not the same as using it, you might nevertheless consider giving the financial stability regulator similar authority to take prompt corrective action with respect to any systemically important financial institution or group if certain events occur, such as becoming undercapitalized, being in an unsafe or unsound condition or engaging in an unsafe or unsound practice. The trigger events and permissible actions could be modeled on those contained in Section 38 of the Federal Deposit Insurance Act.

14. Resolution Powers

One of the most important gaps exposed during the current financial crisis was the lack of federal resolution powers for systemically important financial institutions or groups. The Federal Deposit Insurance Corporation ("FDIC") has broad powers to act as a conservator or receiver of a failed or severely troubled bank. These powers include the ability to control the process, to repudiate burdensome contracts, to transfer certain assets and liabilities to a bridge bank, and to enter into loss-sharing and other financial assistance arrangements designed to maximize the value of the failed institution to the system. This is the power the FDIC used to resolve WaMu, IndyMac and other thrifts. The Federal

Housing Finance Authority exercised similar powers when it placed Fannie and Freddie into conservatorship.

No similar resolution power was available to the government to resolve Lehman Brothers or AIG. Lehman Brothers was allowed to fail largely because no one was willing to step in to acquire Lehman Brothers before it filed for bankruptcy. AIG was rescued initially with a use of the Federal Reserve's authority under Section 13(3) of the Federal Reserve Act and subsequently by money from the Troubled Asset Relief Program.

The Bankruptcy Code or state insurance insolvency codes may not give the government sufficient control over the resolution of systemically important financial institutions and groups. Instead, you might consider giving the financial markets stability regulator the authority to appoint itself or another federal regulatory agency (including the FDIC) as the conservator or receiver of any systemically important financial institution or group. If you do, you might also consider giving it resolution powers similar to those contained in Sections 11 and 13 of the Federal Reserve Act.

15. Emergency Financial Assistance

Another important gap in the system exposed by the financial crisis is the lack of any regulator with the power to provide emergency financial assistance to any systemically important financial institution or group in order to prevent systemic risk. The FDIC has the power to provide such assistance to banks, but its power does not extend to financial institutions generally or even to bank holding companies. Moreover, it is generally precluded from providing such "open bank"

assistance unless it would be less costly to the deposit insurance fund than closing the bank or if necessary to prevent systemic risk. But the FDIC has been very reluctant to expose the deposit insurance fund even to prevent systemic risk. In fact, but for the short-lived assistance promised in the Citi-Wachovia transaction, the FDIC has not agreed to provide any open bank assistance since 1992.

According to public reports, this has created a certain amount of tension among some of the federal agencies during the financial crisis. The agencies most concerned about systemic risk have not always had clear authority or sufficient resources to provide emergency assistance. The agency that did – the FDIC – has been very reluctant to provide it. If Congress decides to create a financial markets stability regulator and give it resolution powers, it might also consider giving it clear authority over the decision whether to provide emergency financial assistance to prevent a systemic crisis. There should be some limits on the exercise of that power to make sure it does not create moral hazard. One proposal might be to require the financial markets stability regulator to consult with the Secretary of the Treasury and the President, before providing emergency financial assistance to a systemically important financial institution.

D. There Are a Number of Options for Who Might Be the Financial Markets Stability Regulator

There are a number of options for who might be the financial markets stability regulator. One option is to create a new independent federal agency, possibly within Treasury. Another option is a panel of regulators such as the President's Working Group. Yet another option is to make the Federal Reserve the financial markets stability regulator.

Each of these options has advantages and disadvantages. Whichever option is selected, the financial markets stability regulator should have the right balance between accountability to and independence from the political process. It needs to have credibility in the markets and with regulators in other countries. It should have the tools necessary to identify systemic risk, take prompt action to prevent a financial crisis and resolve a financial crisis if it occurs. To be truly effective, the financial markets stability regulator would need to have the power to act as the lender of last resort or to provide emergency financial assistance to the markets, and to have prompt corrective action and resolution powers over failed or failing financial institutions that are systemically important.

A new federal agency could be singularly focused on the critical mission of financial stability. It could be structured to avoid conflicts between its role as financial markets stability regulator and other roles such as that of monetary policy authority. It would likely be more accountable to Congress and less independent than the Federal Reserve. But a new regulatory agency would require a large new budgetary appropriation to staff and fund its activities, as well as substantial time to establish, become fully functional and become credible domestically and internationally. Indeed, this entire process could take several years. There are risks in delaying an effective financial markets stability regulator for too long. Finally, a new regulator might not be given enough independence from the political process to provide confidence to the market.

A panel of regulators such as the President's Working Group might bring together more collective expertise than either a new regulator or the Federal

Reserve. But issues of coordination and collective accountability are a concern. This model has the potential to perpetuate the risk of continued gaps, duplication, inefficiency and waste compared to a single oversight body.

Unlike a new regulatory agency, the Federal Reserve already has a window into the overall U.S. and global markets. It has an experienced staff and the ability to expand its resources with revenues from its open market activities. It has a long tradition of independence, giving it essential credibility with the markets. It also has strong credibility with regulators around the world with which the financial markets stability regulator would need to coordinate. Its tool kit includes many of the tools that we believe are essential for the financial markets stability regulator. For example, it already has the ability to act as the lender of last resort and to provide emergency financial assistance during a financial crisis. These tools probably need to be modernized in light of the lessons learned from the financial crisis, but the Federal Reserve already has them and issues concerning coordination with another body in the event of a financial crisis would be avoided. The Federal Reserve also has experience and a credible track record using these tools responsibly and sparingly. Finally, expanding the Federal Reserve's powers to include those of a financial markets stability regulator could be done relatively quickly and would result in a single regulator being accountable for systemic risk across all financial institutions and markets.

The principal arguments against the Federal Reserve boil down to fears about the concentration of too much power and responsibility in the Federal Reserve and concerns about its independence in conducting monetary policy. In

addition, the Federal Reserve would still need to coordinate with the functional regulators unless it is also going to take over their powers, which may not be feasible or desirable. Some critics also point out that the Federal Reserve has not been blameless in failing to identify and take corrective action against systemic risk in time to prevent the current financial crisis.

In addition, if the Federal Reserve is the financial markets stability regulator, you might want to consider the breadth of its duties and whether certain other functions should remain with the Federal Reserve. Also, you might want to consider how Congress should supervise and oversee the Federal Reserve in such a role if it is the financial markets stability regulator.

E. International Cooperation and Coordination

The current financial crisis reminds us that markets are global in nature and so are the risks of contagion. To promote investor protection through effective regulation and the elimination of disparate regulatory treatment, we believe that common regulatory standards should be applied consistently across markets. Accordingly, we urge that steps be taken to foster greater cooperation and coordination among regulators in major markets in the U.S., Europe, Asia, and elsewhere around the world. There are several international groups in which the U.S. participates that work to further regulatory cooperation and establish international standards, including IOSCO, the Joint Forum, the Basel Committee on Banking Supervision, and the Financial Stability Forum. Congress should support and encourage the efforts of these groups.

III. Conclusion

Recent challenges have highlighted the necessity of a fundamental review of our regulatory system. SIFMA strongly supports these efforts and commits to be a constructive participant in the process. SIFMA stands ready to assist the Committee as it considers systemic risk and the proposal to create a new federal regulator to be responsible for identifying and controlling systemic risk. We are confident that through our collective efforts, we have the capacity to emerge from this crisis with stronger and more modern regulatory oversight that will not only prepare us for the challenges facing financial firms today and in the future, but also help the investing public meet its financial needs and support renewed economic growth and job creation.

Testimony of Damon A. Silvers

Associate General Counsel

American Federation of Labor and Congress of Industrial Organizations

Perspectives on Regulation of Systemic Risk in the Financial Services Industry

House Financial Services Committee

March 17, 2009

Good morning Chairman Frank and Ranking Member Bachus. My name is Damon Silvers and I am Associate General Counsel of the AFL-CIO and Deputy Chair of the Congressional Oversight Panel. My testimony today is on behalf of the AFL-CIO. Though I will refer to the Congressional Oversight Panel's report on regulatory reform mandated by the Emergency Economic Stabilization Act of 2008, my testimony reflects my views and those of the AFL-CIO, and does not necessarily reflect the views of the Congressional Oversight Panel, its chair or its staff. I have attached as appendices recent statements of the AFL-CIO Executive Council addressing financial regulation.

Systemic crises in financial markets harm working people. Damaged credit systems destroy jobs rather than create them. Pension funds with investments in panicked markets see their assets deteriorate. And the resulting instability undermines business' ability to plan and obtain financing for new investments—undermining the long term growth and competitiveness of employers and setting the stage for future job losses. The AFL-CIO has urged Congress since 2006 to act to reregulate shadow financial markets, and the AFL-CIO supports addressing systemic risk.

The Congressional Oversight Panel made the following recommendations with respect to addressing systemic risk, recommendations which the AFL-CIO supports.

1) There should be a body charged with monitoring sources of systemic risk in the financial system.[1] The Panel did not make recommendations as to the precise structure of such a body; however, the AFL-CIO believes systemic risk regulation should be the responsibility of a coordinating body of regulators, chaired by the Chairman of the Board of Governors of the Federal Reserve System. This body should have its own staff, with the resources and expertise to monitor sources of systemic risk in institutions and products throughout the financial markets.

2) The body charged with systemic risk management should be fully accountable and transparent to the public in a manner that exceeds the general accountability mechanisms present in self-regulatory bodies such as the regional Federal Reserve Banks that execute the Fed's current regulatory responsibilities.

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[1] Congressional Oversight Panel, Special Report on Regulatory Reform, at 22-24 (Jan. 29, 2009), *available at* http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf.

3) We should not identify specific institutions in advance as too big to fail, but rather have a regulatory framework in which institutions have higher capital requirements and pay more on insurance funds on a percentage basis than smaller institutions which are less likely to be rescued as being too systemic to fail.

4) Systemic risk regulation cannot be a substitute for routine disclosure, accountability, safety and soundness, and consumer protection regulation of financial institutions and financial markets, nor can reform in the area of systemic risk regulation be a substitute for strengthening the overall financial regulatory framework. Tieing systemic risk regulation to the weakening of routine regulation, as the Paulsen Treasury blueprint did, would be a potentially catastrophic mistake.

5) Ironically, effective protection against systemic risk requires that the shadow capital markets—institutions like hedge funds and products like credit derivatives—must not only be subject to systemic risk oriented oversight but must also be brought within a framework of routine capital market regulation by agencies like the Securities and Exchange Commission. We can no longer tolerate a Swiss cheese system of financial regulation. This is particularly true in light of announced plans to have the Treasury Department and the Federal Reserve fund transactions with these shadow market institutions as part of TARP.

6) Finally, there will not be effective reregulation of the financial markets without a global regulatory floor.

The Congressional Oversight Panel urged attention be paid to executive compensation in financial institutions, with particular attention to issues of incentives with regard to risk and time horizons. This is an issue of particular concern to the AFL-CIO that I want to turn to now in some detail in relation to systemic risk.

Executive pay in financial institutions is a source of systemic risk when companies structure their pay packages to effectively encourage executives to take risks that their firms' capital structure cannot support. There are two basic ways executive pay structures do this. First, by having short term time horizons that enable executives to cash out their incentive pay before the full consequences of their actions are known. The poster child for this problem is Countrywide's pay package for Angelo Mozilo, that allowed Mr. Mozilo to take out over $400 million in incentive compensation during the four year period before Countrywide collapsed.[2]

The second problem is the problem of risk asymmetry. When an investor holds a stock, the investor is exposed to upside risk and downside risk in equal proportion. For every dollar of value lost or gained, the stock moves proportionately. But when an executive is compensated with stock options, the upside works like a stock, but the downside is effectively capped—once the stock falls well below the strike price of the option, the executive is relatively indifferent to

[2] During the height of the real estate bubble between 2004 and 2007, Mozilo exercised stock options valued at $414 million, prompting an informal U.S. Securities and Exchange Commission (SEC) investigation into the sales. *See* Countrywide Seeks Rescue Deal, WALL ST. J. (Jan. 11, 2008).

further losses. This creates an incentive to focus on the upside, and be less interested in the possibility of things going really wrong. It is a terrible way to incentivize the manager of a major financial institution, and a particularly terrible way to incentivize the manager of an institution the Federal government might have to rescue.

This is highly relevant to the situation of sick financial institutions. When stock prices have fallen to close to zero, stocks themselves behave like options from an incentive perspective. Thus it is very dangerous to have sick financial institutions run by people who are incentivized by the stock price. You are basically asking them to take destructive risks from the perspective of anyone, like the federal government, who might have to cover the downside. This problem today exists at institutions like AIG and Citigroup not just for the CEO or the top five executives, but for hundreds of members of the senior management team.

A further source of asymmetric risk incentives is the combination of equity based compensation with large severance packages. As we have learned, disastrous failure in financial institutions sometimes leads to getting fired, but rarely leads to getting fired for cause. The result is the failed executive gets a large severance package. If success leads to big payouts, and failure leads to big payouts, but modest achievements either way do not, then there is once again a big incentive to shoot the moon without regard to downside risk.

These sorts of pay packages in just one very large financial institution can be a source of systemic risk. But when such packages are the norm throughout the financial services sector, they are a system wide source of risk; much as certain types of unregulated derivatives, or asset backed securities can be a source of system wide risk.

The AFL-CIO has sought to move executive pay practices away from asymmetric, short term structures. We have helped lead initiatives with the business community like the Aspen Institute's Principles for Long-Term Value Creation that address executive pay time horizons.[3] We have sponsored shareholder proposals at financial institutions seeking to require equity based pay be held beyond retirement.[4] Increased SEC disclosure can give long-term investors better tools, but for financial institutions there must be direct involvement by safety and soundness regulators in monitoring both the time horizons and risk sensitivity of pay packages, and the agency charged with systemic risk regulation must monitor pay structures within financial institutions as they would monitor the [development of new financial products?].

The remainder of my testimony deals in detail with a number of issues raised by the problem of systemic risk—including the definition and history of the problem, lessons from the current

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[3] The Aspen Institute, Long-Term Value Creation: Guiding Principles for Corporations and Investors, *available at* http://www.aspeninstitute.org/sites/default/files/content/docs/business%20and%20society%20program/FINALPRINCIPLES.PDF.

[4] The AFL-CIO has filed proposals at Bank of NY Mellon, Citigroup, JP Morgan Chase, and AIG (co-filed with the American Federation of State County and Municipal Employees) urging each company to adopt a policy requiring senior executives to retain 75% of the shares acquired through compensation plans for two years following the termination of their employment and to report to shareholders regarding the policy before the Company's 2010 annual meeting.

financial crisis, structural issues associated with systemic risk regulation, issues of how to substantively regulate systemic risk, and the powers a systemic risk regulator should have.

What is Systemic Risk

The concept of systemic risk is that financial market actors can create risk not just that their institutions or portfolios will fail, but risk that the failure of their enterprises will cause a broader failure of other financial institutions and that such a chain of broader failures can jeopardize the functioning of financial markets as a whole. As Chairman Bernanke has recently noted, systemic risk can reside in firms and products, in the infrastructure of the financial markets, in pro-cyclical regulatory policies, and in larger economic developments like imbalances in international fund flows.[5] The mechanisms by which this broader failure can occur involve a loss of confidence in information, or a loss of confidence in market actors' ability to understand the meaning of information, which leads to the withdrawal of liquidity from markets and market institutions. Because the failure of large financial institutions can have these consequences, systemic risk management generally is seen to both be about how to determine what to do when a systemically significant institution faces failure, and about how to regulate such institutions in advance to minimize the chances of systemic crises.

History of Federal Policy with Respect to Systemic Risk

Historically, the United States has had three approaches to systemic risk. The first was prior to the founding of the Federal Reserve System, when there was reluctance at the federal level to intervene in any respect in the workings of credit markets in particular and financial markets in general. The Federal Reserve System, created after the financial collapse of 1907, ushered in an era where the federal government's role in addressing systemic risk largely consisted of sponsoring, through the Federal Reserve System, a means of providing liquidity to member banks, and thus hopefully preventing the ultimate liquidity shortage that results from market participants losing confidence in the financial system as a whole.[6]

But then, after the Crash of 1929 and the four years of Depression that followed, Congress and the Roosevelt Administration adopted a regulatory regime whose purpose was to substantively regulate financial markets in a variety of ways.[7] This new approach arose out of a sense among policymakers that the systemic financial crisis associated with the Great Depression resulted from the interaction of weakly regulated banks with largely unregulated securities markets, and that exposing depositors to these risks was a systemic problem in and of itself. Such centerpieces of our regulatory landscape as the Federal Deposit Insurance Corporation and the Securities and Exchange Commission's disclosure based system of securities regulation came into being not just as systems for protecting the economic interests of depositors or investors, but

[5] Speech to the Council on Foreign Relations, March 10, 2009, available at http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm.

[6] The Federal Reserve System: Purposes & Functions at 1-2, *available at* http://www.federalreserve.gov/pf/pdf/pf_complete.pdf.

[7] *Id* at 59-74.

as mechanisms for ensuring systemic stability by, respectively, walling off bank depositors from broader market risks, and ensuring investors in securities markets had the information necessary to make it possible for market actors to police firm risk taking and to monitor the risks embedded in particular financial products.

In recent years, financial activity has moved away from regulated and transparent markets and institutions and into the so-called shadow markets. Regulatory barriers like the Glass-Steagall Act that once walled off less risky from more risky parts of the financial system have been weakened or dismantled.[8] So we entered the recent period of extreme financial instability with an approach to systemic risk that looked a lot like that of the period following the creation of the Federal Reserve Board but prior to the New Deal era. And so we saw the policy response to the initial phases of the current financial crisis primarily take the form of increasing liquidity into credit markets through interest rate reductions and increasingly liberal provision of credit to banks and then to non-bank financial institutions.

With the collapse of Lehman Brothers and the federal rescues of AIG, FNMA, and the FHLMC, the federal response to the perception of systemic risk turned toward much more aggressive interventions in an effort to ensure that after the collapse of Lehman Brothers, there would be no more defaults by large financial institutions. This approach was made somewhat more explicit with the passage of the Emergency Economic Stabilization Act of 2008 and the commencement of the TARP program.

Lessons from the Current Financial Crisis

We can now learn some lessons from this experience for the management of systemic risk in the financial system.

First, our government and other governments around the world will step in when major financial institutions face bankruptcy. We do not live in a world of free market discipline when it comes to large financial institutions, and it seems unlikely we ever will. If two administrations as different as the Bush Administration and the Obama Administration agree that the federal government must act when major financial institutions fail, it is hard to imagine the administration that would do differently. Since the beginning of 2008, we have used federal dollars in various ways to rescue either the debt or the equity holders or both at the following companies—Bear Stearns, Indymac, Washington Mutual, AIG, Merrill Lynch, Fannie Mae, Freddie Mac, Citigroup and Bank of America. But we have no clear governmental entity charged with making the decision over which company to rescue and which to let fail, no clear criteria for how to make such decisions, and no clear set of tools to use in stabilizing those that must be stabilized.

[8] For a comprehensive discussion of deregulation from 1975 through 2000, see Wilmarth, Arthur E.,The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation and Increased Risks. University of Illinois Law Review, Vol. 2002, No. 2 at 240, 2002. Available at SSRN: http://ssrn.com/abstract=315345.

Second, we appear to be hopelessly confused as to what it means to stabilize a troubled financial institution to avoid systemic harm. We have a longstanding system of protecting small depositors in FDIC insured banks, and by the way policyholders in insurance companies through the state guarantee funds. The FDIC has a process for dealing with banks that fail—a process that does not always result in 100% recoveries for uninsured creditors. Then we have the steps taken by the Treasury Department and the Federal Reserve since Bear Stearns collapsed. At some companies, like Fannie Mae and Freddie Mac, those steps have guaranteed all creditors, but wiped out the equity holders. At other companies, like Bear Stearns, AIG, and Wachovia, while the equity holders survive, they have been massively diluted one way or another. At others, like Citigroup and Bank of America, the equity has been only modestly diluted when looked at on an upside basis. It is hard to understand exactly what has happened with the government's interaction with Morgan Stanley and Goldman Sachs, but again there has been very little equity dilution. And then there is poor Lehman Brothers, apparently the only non-systemic financial institution, where everybody lost. In crafting a systematic approach to systemically significant institutions, we should begin with the understanding that while a given financial institution may be systemically significant, not every layer of its capital structure should be necessarily propped up with taxpayer funds.

Third, much regulatory thinking over the last couple of decades has been shaped by the idea that sophisticated parties should be allowed to act in financial markets without regulatory oversight. Candidly, institutional investors have been able to participate in a number of relatively lightly regulated markets based on this idea. But this idea is wrong. Big, reckless sophisticated parties have done a lot of damage to our financial system and to our economy. I do not mean to say that sophisticated parties in the business of risk taking should be regulated in the same way as auto insurers selling to the general public. But there has to be a level of transparency, accountability, and mandated risk management across the financial markets.

Fourth, financial markets are global now. Norwegian villages invest in U.S. mortgage backed securities.[9] British bankruptcy laws govern the fate of U.S. clients of Lehman Brothers, an institution that appeared to be a U.S. institution.[10] AIG, our largest insurance company, collapsed because of a London office that employed 377 of AIG's 116,000employees.[11] Chinese industrial workers riot when U.S. real estate prices fall. These are just a few illustrations of how global our financial markets have become, yet we increasingly live in a world where the least common denominator in financial regulation rules.

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[9] Steven Pearlstein, It's Not 1929, but It's the Biggest Mess Since, WASHINGTON POST (Dec. 5, 2007), *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/12/04/AR2007120402186_pf.html.

[10] Mathieu Robbins, Lehman's bankruptcy '10 times more complicated than Enron', THE INDEPENDENT (Nov. 15, 2008), *available at* http://www.independent.co.uk/news/business/news/lehmans-bankruptcy-10-times-more-complicated-than-enron-1019875.html.

[11] Gretchen Morgenson, Behind Insurer's Crisis, Blind Eye to a Web of Risk, NY TIMES (Sept. 27, 2008), *available at* http://www.nytimes.com/2008/09/28/business/28melt.html?em=&pagewanted=all.

Further Observations on Regulating Systemic Risk

Structure

Regulating systemic risk requires as much access as possible to all information extant about the condition of the financial markets—including not just bank credit markets, but securities, commodities, and futures markets, and consumer credit markets. As long as we have the fragmented bank regulatory system we now have, this body would need access to information about the state of all deposit taking institutions. The reality of the interagency environment is that for information to flow freely, all the agencies involved need some level of involvement with the agency seeking the information. Connected with the information sharing issue is expertise. It is unlikely a systemic risk regulator would develop deep enough expertise on its own in all the possible relevant areas of financial activity. To be effective it would need to cooperate in the most serious way possible with all the routine regulators where the relevant expertise would be resident.

While many have argued the need for a systemic risk regulator to be fully public in the hope that would make for a more effective regulatory culture, the TARP experience highlights a much more bright line problem. An effective systemic risk regulator must have the power to bail out institutions, and the experience of the last year is that liquidity provision is simply not enough in a real crisis. An organization that has the power to expend public funds to rescue private institutions must be a public organization—though it should be insulated from politics much as our other financial regulatory bodies are by independent agency structures.

Here is where the question of the role of the Federal Reserve comes in. A number of commentators and Fed officials have pointed out that the Fed has to be involved in any body with rescue powers because any rescue would be mounted with the Fed's money. However, the TARP experience suggests this is a serious oversimplification. While the Fed can offer liquidity, many actual bailouts require equity infusions, which the Fed cannot currently make, nor should it be able to, as long as the Fed continues to seek to exist as a not entirely public institution. In particular, the very bank holding companies the Fed regulates are involved in the governance of the regional Federal Reserve Banks that are responsible for carrying out the regulatory mission of the Fed, and could if the current structure were untouched, be involved in deciding which member banks or bank holding companies would receive taxpayer funds in a crisis.

These considerations also point out the tensions that exist between the Board of Governors of the Federal Reserve System's role as central banker, and the great importance of distance from the political process, and the necessity of political accountability and oversight once a body is charged with dispersing the public's money to private companies that are in trouble. That function must be executed publicly, and with clear oversight, or else there will be inevitable suspicions of favoritism that will be harmful to the political underpinnings of any stabilization effort. One benefit of a more collective approach to systemic risk monitoring is that the Federal Reserve Board could participate in such a body while leaving restructuring responsibilities to other members since involvement in restructuring activities would likely be problematic in terms of the Fed's monetary policy activity.

Regulatory Approach

On the issue of whether to identify and separately regulate systemically significant firms, another lesson of the last eighteen months is that the decision as to whether some or all of the investors and creditors of a financial firm must be rescued cannot be made in advance. In markets that are weak or panicked, a firm that was otherwise seen as not presenting a threat of systemic contagion might be seen as doing just that. Conversely, in a calm market environment, it may be the better course of action to let a troubled firm go bankrupt even if it is fairly large. Identifying firms ex ante as systemically significant also makes the moral hazard problems much more intense.

The AFL-CIO believes effective systemic risk management in a world of diversified institutions would require some type of universal systemic risk insurance program or tax. Such a program would appear to be necessary to the extent the federal government is accepting it may be in a position of rescuing financial institutions in the future. Such a program would be necessary both to cover the costs of such interventions and to balance the moral hazard issues associated with systemic risk management. However, there are practical problems defining what such a program would look like, who would be covered and how to set premiums. One approach would be to use a financial transactions tax as an approximation. The global labor movement has indicated its interest in such a tax on a global basis, in part to help fund global reregulation of financial markets.

More broadly, these issues return us to the question of whether the dismantling of the approach to systemic risk embodied in the Glass-Steagall Act was a mistake. It appears that we are now in a position where we cannot wall off more risky activities like credit default swaps from less risky liabilities like demand deposits or commercial paper that we wish to insure. On the other hand, it seems mistaken to try to make large securities firms behave as if they were commercial banks. Those who want to maintain the current dominance of integrated bank holding companies in the securities business should have some burden of explaining how their securities businesses plan to act now that they have an implicit government guaranty.

Finally, the AFL-CIO believes very strongly that the regulation of the shadow markets, and of the capital markets as a whole cannot be shoved into the category labeled "systemic risk regulation," and then have that category be effectively a sort of night watchman effort. The lesson of the failure of the Federal Reserve to use its consumer protection powers to address the rampant abuses in the mortgage industry earlier in this decade is just one of several examples going to the point that without effective routine regulation of financial markets, efforts to minimize the risk of further systemic breakdowns are unlikely to succeed. We even more particularly oppose this type of formulation that then hands responsibility in the area of systemic risk regulation over to self-regulatory bodies.

Powers of a Systemic Risk Regulator

As Congress moves forward to address systemic risk management, one area that we believe deserves careful consideration is how much power to give to a body charged with systemic risk management to intervene in routine regulatory policies and practices. There are a range of options, ranging from power so broad it would amount to creating a single financial services super regulator, e.g. vesting such power in staff or a board chairman acting in an executive

capacity, to arrangements requiring votes or supermajorities, to a system where the systemic risk regulator is more of a scout than a real regulator, limited in its power to making recommendations to the larger regulatory community. The AFL-CIO would tend to favor a choice somewhere more in the middle of that continuum. We strongly support the view stated by Professor Jack Coffee of Columbia University that a systemic regulator should not have the authority to override investor and consumer protection rules, particularly disclosure related rules promulgated by the relevant regulators.

Finally, with respect to the jurisdiction and the reach of a systemic risk regulator, we believe it must not be confined to institutions per se, or products or markets, but must extend to all financial activity.

Conclusion

The AFL-CIO appreciates the opportunity to testify today, and commends this Committee for its leadership in this area, and its insistence that financial regulation needs to be strengthened. We urge the Committee to undertake a comprehensive strengthening of the financial regulatory system. The AFL-CIO would be pleased to assist this Committee in any way possible as the Committee takes up these critical tasks. Thank you.

Bank Bailouts

March 05, 2009

Miami, Fla.

AFL-CIO Executive Council statement

There has been a dramatic concentration of banking power since the Gramm-Leach-Bliley Act repealed New Deal bank regulation. More than 43 percent of U.S. bank assets are held by just four institutions: Citigroup, Bank of America, Wells Fargo and JP Morgan Chase. When these institutions are paralyzed, our whole economy suffers. When banks appear on the brink of collapse, as several have repeatedly since September, government steps in. The free market rules that workers live by do not apply to these banks.

Since Congress passed financial bailout legislation in October, working people have seen our tax dollars spent in increasingly secretive ways to prop up banks that we are told are healthy, until they need an urgent bailout. In some instances, institutions that were bailed out need another lifeline soon after. The Congressional Oversight Panel, charged with overseeing the bailout, recently found that the federal government overpaid by $78 billion in acquiring bank stock.

The AFL-CIO believes government must intervene when systemically significant financial institutions are on the brink of collapse. However, government interventions must be structured to protect the public interest, and not merely rescue executives or wealthy investors. This is an issue of both fairness and our national interest. It makes no sense for the public to borrow trillions of dollars to rescue investors who can afford the losses associated with failed banks.

The most important goal of government support must be to get banks lending again by ensuring they are properly capitalized. This requires forcing banks to acknowledge their real losses. By feeding the banks public money in fits and starts, and asking little or nothing in the way of sacrifice, we are going down the path Japan took in the 1990s—a path that leads to "zombie banks" and long-term economic stagnation.

The AFL-CIO calls on the Obama administration to get fair value for any more public money put into the banks. In the case of distressed banks, this means the government will end up with a controlling share of common stock. The government should use that stake to force a cleanup of the banks' balance sheets. The result should be banks that can either be turned over to bondholders in exchange for bondholder concessions or sold back into the public markets. We believe the debate over nationalization is delaying the inevitable bank restructuring, which is something our economy cannot afford.

A government conservatorship of the banks has been endorsed by leading economists, including Nouriel Roubini, Joseph Stiglitz and Paul Krugman. Even Alan Greenspan has stated it will probably be necessary.

The consequences of crippled megabanks are extraordinarily serious. The resulting credit paralysis affects every segment of our economy and society and destroys jobs. We urge President

Obama and his team to bring the same bold leadership to bear on this problem as they have to the problems of economic stimulus and the mortgage crisis.

Financial Regulation

March 05, 2009

Miami, Fla.

AFL-CIO Executive Council statement

Deregulated financial markets have taken a terrible toll on America's working families. Whether measured in lost jobs and homes, lower earnings, eroding retirement security or devastated communities, workers have paid the price for Wall Street's greed. But in reality, the cost of deregulation and financial alchemy are far higher. The lasting damage is in missed opportunities and investments not made in the real economy. While money poured into exotic mortgage-backed securities and hedge funds, our pressing need for investments in clean energy, infrastructure, education and health care went unmet.

So the challenge of reregulating our financial markets, like the challenge of restoring workers' rights in the workplace, is central to securing the economic future of our country and the world. In 2006, while the Bush administration was in the midst of plans for further deregulation, the AFL-CIO warned of the dangers of unregulated, leveraged finance. That call went unheeded as the financial catastrophe gathered momentum in 2007 and 2008, and now a different day is upon us. The costs of the deregulation illusion have become clear to all but a handful of unrepentant ideologues, and the public cast its votes in November for candidates who promised to end the era of rampant financial speculation and deregulation.

In October, when Congress authorized the $700 billion financial bailout, it also established an Oversight Panel to both monitor the bailout and make recommendations on financial regulatory reform. The panel's report lays the foundation for what Congress and the Obama administration must do.

First, we must recognize that financial regulation has three distinct purposes: (1) ensuring the safety and soundness of insured, regulated institutions; (2) promoting transparency in financial markets; and (3) guaranteeing fair dealing in financial markets, so investors and consumers are not exploited. In short, no gambling with public money, no lying and no stealing.

To achieve these goals, we need regulatory agencies with focused missions. We must have a revitalized Securities and Exchange Commission (SEC), with the jurisdiction to regulate hedge funds, derivatives, private equity and any new investment vehicles that are developed. The Commodity Futures Trading Commission should be merged with the SEC to end regulatory arbitrage in investor protection.

Second, we must have an agency focused on protecting consumers of financial services, such as mortgages and credit cards. We have paid a terrible price for treating consumer protection as an afterthought in bank regulation.

Third, we need to reduce regulatory arbitrage in bank regulation. At a minimum, the Office of Thrift Supervision, the regulator of choice for bankrupt subprime lenders such as Washington Mutual and IndyMac, should be consolidated with other federal bank regulators.

Fourth, financial stability must be a critical goal of financial regulation. This is what is meant by creating a systemic risk regulator. Such a regulator must be a fully public agency, and it must be able to draw upon the information and expertise of the entire regulatory system. While the Federal Reserve Board of Governors must be involved in this process, it cannot undertake it on its own.

We must have routine regulation of the shadow capital markets. Hedge funds, derivatives and private equity are nothing new—they are just devices for managing money, selling insurance and securities and engaging in the credit markets without being subject to regulation. As President Obama said during the campaign, "We need to regulate institutions for what they do, not what they are." Shadow market institutions and products must be subject to transparency and capital requirements and fiduciary duties befitting what they are actually doing.

Reform also is required in the incentives governing key market actors around executive pay and credit rating agencies. There must be accountability for this disaster in the form of clawbacks for pay awarded during the bubble. According to Bloomberg, the five largest investment banks handed out $145 billion in bonuses in the five years preceding the crash, a larger amount than the GDP of Pakistan and Egypt.

Congress and the administration must make real President Obama's commitment to end short-termism and pay without regard to risk in financial institutions. The AFL-CIO recently joined with the Chamber of Commerce and the Business Roundtable in endorsing the Aspen Principles on Long-Term Value Creation that call for executives to hold stock-based pay until after retirement. Those principles must be embodied in the regulation of financial institutions. We strongly support the new SEC chair's effort to address the role played by weak boards and CEO compensation in the financial collapse. With regard to credit rating agencies, Congress must end the model where the issuer pays.

Financial reregulation must be global to address the continuing fallout from deregulation. The AFL-CIO urges the Obama administration to make a strong and enforceable global regulatory floor a diplomatic priority, beginning with the G-20 meeting in April. The AFL-CIO has worked closely with the European Trade Union Congress and the International Trade Union Confederation in ensuring that workers are represented in this process. We commend President Obama for convening the President's Economic Recovery Advisory Board, chaired by former Federal Reserve Chair Paul Volcker, author of the G-30 report on global financial regulation, and we look forward to working with Chairman Volcker in this vital area.

Reregulation requires statutory change, regulatory change, institutional reconstruction and diplomatic efforts. The challenge is great, but it must be addressed, even as we move forward to restore workers' rights and revive the economy more broadly.

Corporate Greed and Retirement Security

August 05, 2008

Chicago

AFL-CIO Executive Council statement

Corporate greed and spiraling executive compensation reinforce the growing inequality in our society. In the area of retirement, some companies are shedding their pension plans by declaring bankruptcy, letting CEOs keep their golden parachutes and leaving workers and retirees holding the bag. The long-term health of pension plans, and the retirement security of the workers and families who rely upon them, also are threatened by conflicts of interest on Wall Street and in the boardroom, a lack of accountability of executives to shareholders and outright corporate fraud.

In their assault on retirement security, well-paid chief executives have decided that secure defined-benefit pensions are too expensive for everyone except themselves. In 1980, roughly half of the nation's private-sector workers were covered by defined-benefit pension plans, with typical employer contributions of about 8 percent of payroll. Today, less than 20 percent of the private-sector workforce participates in such plans. More than 40 percent (according to the Bureau of Labor Statistics) have a 401(k) or other defined-contribution account, with employer contributions averaging less than 3 percent of pay. Hidden in this change is a 5 percent real pay cut.

In the midst of this attack on secure retirement, we now learn that companies are raiding worker pensions to fund already lavish CEO retirement packages. According to a recent news report, companies have "collectively moved hundreds of millions of dollars in obligations for executive benefits into rank-and-file pension plans." This enables companies to capture tax breaks "intended for pensions of regular workers and use them to pay for executives' supplemental benefits and compensation." (The Wall Street Journal, 8/4/08)

This outrageous practice threatens the long-term health of worker's pension plans and forces taxpayers to finance already excessive executive compensation. According to the same article, companies and their consultants have deliberately sought to hide this practice, and it appears that the IRS and other regulatory authorities have failed to monitor and police this tax dodge.

Workers' deferred wages in the form of pensions are not piggy banks for tax avoidance by conflicted consultants and overpaid executives. We urge Congress to investigate this practice fully, provide for greater transparency and close loopholes that allow this to occur.

Congress must also adopt measures to preserve and protect existing pension plans, ensure that employees have a voice in governing their own pension assets, prevent corporations from using the bankruptcy courts to escape pension obligations while richly rewarding executives and ensure adequate retirement security and income through a national pension policy.

Financialization, Financial Market Deregulation and the Credit Crisis

March 05, 2008

San Diego

AFL-CIO Executive Council statement

The implosion of the housing market and the cascading crises in the credit markets are the direct consequence of a 30-year experiment of trying to create a deregulated, low wage economy where high consumer spending is propped up by easy credit and asset bubbles. Real solutions must be based on restoring the economic health of the American middle class through good jobs, health care, retirement security and a voice at work for all. And an important part of the solution must be the thoughtful, comprehensive re-regulation of the financial markets.

The AFL-CIO has long favored greater investor protections and regulatory oversight of participants in the U.S. financial markets. As we meet, much of the mortgage market, the municipal bond market, the market for riskier corporate debt, and in the last week the student loan market, are frozen—the result of speculative excess and a massive loss of confidence in the information available to investors. Only thoughtful re-regulation can restore that confidence and the ability of the markets to properly function.

The damage to working families is real, and growing. Working people are losing their homes at an alarmingly rate. Jobs in residential construction, one of the largest construction industry markets, are disappearing. Perfectly good companies are unable to finance their businesses. And workers' pension funds have suffered tens of billions of dollars in losses from their investments in financial services companies and housing-sector companies battered by subprime losses.

Reining in financial intermediaries after a 30-year free-for-all will be a complex task requiring coordinated action involving Congress and regulators at the state, federal international levels. Given the irresponsible attitude of many in the Bush administration, we must assume that at best only the first steps will be possible while that administration remains in office.

Effective regulation must be implemented to ensure the transparency and accountability of mortgage lenders, investment banks, credit-rating agencies, hedge funds, private equity funds, off-balance-sheet lending vehicles and other structured credit products, as well as Sovereign Wealth Funds. The AFL-CIO has called repeatedly for transparency and clear fiduciary duties to investors by all pools of private capital and capital market intermediaries. The reasons for such transparency have never been clearer.
The AFL-CIO also has warned repeatedly of the danger of market accounting in contexts where there are no functioning markets or where such accounting can contribute to a downward economic spiral unrelated to the actual business activity of companies. We are now living through a bubble followed by a downward spiral in the credit markets, made worse by applying mark to market accounting where markets have frozen.

As a first step, policymakers must revisit the inherent conflict that exists when fee-based investment banking is combined with the business of taking and investing insured deposits. The repeal of the Glass-Steagall Act by the Gramm-Leach-Bliley Act left this dangerous conflict without any effective oversight. In particular, Congress and the regulators must address compensation structures that reward the taking of excessive risk with federally insured deposits.

Furthermore, regulators here and around the world must deal with the fundamental problem that if a lender can pass off bad loans to an unsuspecting public, keep none of the risk and collect large fees, that institution has no incentive not to make the bad loan in the first place. The AFL-CIO supports the effort of House Banking Committee Chairman Barney Frank to work on these issues on an international basis with the European Parliament.

Credit-rating agencies that gave securitized subprime loans triple A ratings are one of the major causes of this debacle. Congress needs to increase the Securities and Exchange Commission's power to regulate these agencies, possibly through an independent body like the Public Company Accounting Oversight Board created by the Sarbanes-Oxley Act.

Like all investors that rely heavily on borrowing to finance their investments, hedge funds and private equity funds will suffer as lenders tighten their standards. The high-profile failures of leveraged buyouts led by prominent private equity firms including Blackstone and J.C. Flowers are indicative of the difficulties ahead. As we have said in the past, Congress should act (1) to give the regulators power in this area to protect investors and (2) to ensure that our tax system is fair by taxing hedge fund and private equity fees at ordinary income rates.

As a result of nearly three decades of self-destructive trade and energy policies, our trade deficit has given birth to the Sovereign Wealth Funds. Our flagship financial institutions, crippled by their catastrophic involvement in the subprime markets, have recently turned to these funds, who have gained significant levels of ownership in these important institutions. As a result of our trade deficit, our economy has come to depend on flows of foreign capital, and we cannot look to exclude such funds from our markets or take away their rights as investors. Nonetheless, we strongly support the efforts of Sens. Jim Webb, Charles Schumer and Evan Bayh to address the challenges posed by the rise of Sovereign Wealth Funds.

Specifically, Sovereign Wealth Funds should be required to comply with all of the disclosure requirements that apply to domestic investors. In addition, Congress should strengthen the process for U.S. government review when foreign governments invest in U.S. companies by (1) removing provisions that allow foreign investors to escape government review when shares are non-voting, and (2) lowering the ownership level that triggers optional governmental review from 10 percent to 5 percent.

However, not all Sovereign Wealth Funds are the same. Norway's Government Pension Fund provides retirement security for all Norwegians and is a leader in efforts at transparency in the global capital markets. The Norwegian fund should be looked to as a model of the transparency and accountability we should expect from all Sovereign Wealth Funds.

Financial re-regulation will not by itself restore our economy to health. That will require middle class restoration. But thoughtful re-regulation of financial markets is part of what must be done.

We urge Congress and the regulators to act without delay to address the conflicts within financial institutions, bring transparency to opaque pools of capital, and protect consumers and the public interest in the capital markets.

Private Equity and Hedge Funds

August 08, 2007

Chicago

AFL-CIO Executive Council statement

In the past year, the global labor movement has mobilized to address the issue of what John Monks, president of the European Trade Union Confederation, has labeled the "financialization" of the global economy.

Financialization describes the growing dominance of finance over the real economy, and, in the United States at least, over politics as well. At the heart of financialization are the growing size and power of hedge funds and leveraged private equity funds—leveraged private pools of capital that benefit from extensive tax subsidies and are unregulated and shrouded in secrecy.

The AFL-CIO has long favored greater investor protections and regulatory oversight of hedge funds, as the Executive Council reaffirmed in its statement last March. However, the recent dramatic growth in both leveraged private equity and hedge funds has made it necessary to state the labor movement's views on the challenges these funds pose to policymakers, to workers and their unions and to fiduciaries entrusted with workers' capital.

Leveraged buyout funds and hedge funds have been around for years and are not going to disappear. Pension funds and other institutional investors have used them properly in modest amounts to help round out their portfolios and offset the volatility of other investments. But it is both dangerous and illusory to believe that pension funds in general can achieve sustained above-market rates of return for large portions of their portfolios by investing in leveraged asset pools. And there is no reason why these funds should be secretive or unaccountable. Finally, there is no reason why the individuals who manage private equity and hedge funds should receive tax subsidies that leave the burden of paying ordinary tax rates to working people.

It is easy to generate high returns to equity with a combination of cheap debt financing and tax subsidies. That is not a long-term strategy, nor does it require genius—and there is a real cost. There is a hidden cost to the investors who are paying for the leverage with risk, a real cost to workers and their companies that are managed for short-term return and a real cost to the rest of us who subsidize the massive redistribution of our wealth and tax dollars to billionaires.

While leveraged buyouts can provide needed capital to troubled companies, a mania for leveraged finance sets in motion a dynamic in which companies are acquired and hollowed out to make them appealing candidates for being flipped back into the public markets. Workers' jobs, their health and retirement benefits and, in the end, their communities are nothing more than costs that can be converted into debt repayments. America's workers experienced this dynamic in the late 1980s, and now we are experiencing it again.

In response, the AFL-CIO's policy on private equity and hedge funds addresses government policymakers, pension fund fiduciaries and private equity and hedge fund managers themselves.

First, policymakers should enforce our existing laws, protect investors and, most of all, ensure that our tax system is fair. Private pools of capital should be required to play by the same set of rules as everyone else.

The Securities and Exchange Commission should enforce the Investment Company Act and require private equity and hedge funds that wish to sell interests in their underlying investment pools to register as investment companies.

The IRS should look into self-dealing tax avoidance schemes by private equity funds and hedge funds going public. The IRS and the SEC should investigate whether the positions taken by these funds going public with each agency are mutually consistent.

The AFL-CIO strongly endorses both the Grassley-Baucus bill, S. 1624, and the Levin-Rangel bill, H.R. 2834. The Grassley-Baucus bill requires private equity firms and hedge funds that go public to either provide investors with the protections they are entitled to under the Investment Company Act or pay corporate taxes on their earnings, while the Levin-Rangel bill requires hedge fund and private equity managers to pay ordinary income tax rates on their wages like other Americans. We commend the authors and co-sponsors of these bills for their leadership in this area, together with those in Congress who have asked the regulators to enforce the existing tax, investor protection and national security laws. Both bills are badly needed correctives to a tax system that has become grossly unfair.

The AFL-CIO calls upon politicians who think billionaires should have lower tax rates than firefighters and teachers to explain why they deserve the votes of working people.

The AFL-CIO recommends that fiduciaries exercise great care in investing workers' capital in leveraged or opaque private investment vehicles. We urge fiduciaries to invest only in hedge funds that are registered with the SEC as investment advisors, and to ask hedge fund managers to agree to be bound by key protective provisions of ERISA. Some funds also have adopted policies that address the workplace practices of private equity and their impact on long-term value creation.

We particularly urge fiduciaries to work with their asset consultants to ensure the total exposure to either of these categories is modest and the expectations in relation to long-term risk-adjusted returns are realistic.

Finally, the AFL-CIO calls upon the hedge fund and private equity industries to act responsibly—to engage in dialogue both in the United States and globally around investor protection, taxation and workers' rights in the companies they control and influence. There are models for responsible behavior—leveraged buyout firms with a significant history of working productively with workers and their unions, both in the United States and overseas, generating healthy returns while preserving jobs and treating workers with respect.

We particularly urge the industry to engage in a dialogue around investor protection, tax fairness and workers' rights with the global labor movement. America's workers and their unions stand in solidarity with our brothers and sisters around the world in facing the challenge of financialization.

FACT SHEET

MYTHS AND FACTS ABOUT PRIVATE EQUITY AND HEDGE FUNDS

As generally occurs when great wealth and power are concentrated in the hands of a few people, hedge funds and leveraged private equity funds promote a variety of myths about themselves. Fiduciaries and policy makers need to cut through the paid propaganda and focus on the truths behind financialization.

- Neither the term "private equity" nor the term "hedge fund" really describes an asset class. Private equity is a code word for leveraged buyout. There are leveraged buyout firms that borrow money to buy companies, and there are venture capital firms that invest equity in start-up businesses. Almost every "private equity" deal really is a leveraged buyout. As to hedge funds, any asset management strategy can be pursued in the hedge fund form. A hedge fund is a legal structure that avoids regulation in search of an asset class.
- Leveraged private equity and hedge funds do not create money from nothing. Leveraged trading strategies generate high returns by taking on risk through borrowing. That's what the term "leverage" means. Recent studies from Harvard Business School suggest that after adjusting for the high fees and the risk from the leverage, private equity firms may not outperform public markets.
- The business strategy of leveraged buyouts puts them inherently at odds with workers' interest in maintaining living standards, and at odds with our member's interests in having employers and pension funds that focus on long-term value.
- Leveraged buyouts are cyclical—they thrive when risky debt is cheap and stocks are depressed. Recently, long-term debt has been very cheap as China and other countries that run trade surpluses with us look for places to put all the dollars they are accumulating. Tightening credit markets let the air out of leveraged buyouts and can lead to serious losses for leveraged buyout investors.
- Leveraged buyout firms, like their hedge fund relatives, charge their investors extraordinary fees—2 percent of assets managed and 20 percent of the total fund earnings over a benchmark—and pay their partners extraordinary amounts of money. The top 25 hedge fund managers last year earned $14 billion dollars, enough to pay New York City's 80,000 public school teachers for nearly three years.
- Leveraged buyout firms and hedge funds are forms of pooled money management, just like mutual funds. When they try to sell interests in themselves to the investing public, no matter how complex the structure they use to disguise what they are doing, they must be subject to the investor protections of the Investment Company Act.

- Leveraged buyout firms and hedge funds and the people who run them get extraordinary tax breaks that are not justified and that may not in all cases be legal. Private equity and hedge fund managers pay 15 percent capital gains rates on their money management income (called the "carried interest") even though they put no money at risk. Private equity firms and hedge funds that go public tell the SEC they are in the business of active management of companies—but then tell the IRS they are in the business of passive management of securities to get an exemption from paying corporate taxes.

Investor Protection and Corporate Accountability

March 06, 2007

Las Vegas

AFL-CIO Executive Council statement

Since the collapse of Enron and WorldCom, America's workers and their benefit funds have experienced firsthand the consequences of failures in corporate governance for our retirement security, our health care and our jobs. With each passing year, fewer workers have pensions or adequate health care while executive compensation continues to explode, as documented on the AFL-CIO's Executive PayWatch website. In the past year, we have seen scandalous examples of stock options abuses at hundreds of companies and runaway executive pay and exit packages.

Runaway executive pay is the most flagrant example of the growing inequality in American society. We read of Wall Street executives receiving tens of millions of dollars in bonuses and ordering $15,000 bottles of wine—an amount larger than a year's worth of work at the minimum wage. At Pfizer and Home Depot, failed executives left with exit packages exceeding $200 million each.

Excessive executive pay increasingly allows CEOs to gain political influence, in some cases funding political campaigns from their own personal resources. For example, Massey Energy CEO Don Blankenship—who in 2005 alone received $28.8 million in total compensation—spent more than $6 million over the past three years on state elections in an effort to defeat pro-worker candidates and ballot initiatives, according to published reports. America's working families today live in a society in which the wealthy and very wealthy increasingly control political power.

Meanwhile, our nation goes further into debt. In military hospitals without the money to provide proper care, our wounded soldiers suffer¾in many instances from wounds received due to lack of proper equipment. And 18 months after Hurricanes Katrina and Rita struck the Gulf Coast, more than 100,000 people still are unable to return home because the government lacks the resources to act.

These developments are not unrelated to the increased power of short-term investors in the capital markets. Today, hedge funds control more than $1.5 trillion and are subject to almost no oversight, even though much of the money invested in hedge funds comes from workers' pension funds. The international labor movement has become increasingly focused on the combination of hedge funds and private equity funds driving what John Monks, head of the European Trade Union Congress, calls the "financialization" of whole economies. As a result of court decisions and the weakening of ERISA protections by the last Republican Congress, workers' pension assets invested in hedge funds today are less well protected than they ever have been.

Workers and their pension funds are the leading voices in our capital markets for reining in executive pay, holding corporate boards accountable to shareholders, improving our accounting

and auditing systems, and fighting to keep companies and investment managers focused on the long-term goal of creating value for investors and all Americans. Union-affiliated investors now account for a majority of shareholder proposals, addressing such issues as stock option abuse, corporate political contributions, the independence of compensation consultants, the election of company directors (requiring a majority vote) and, for the first time this year, the right of long-term investors to nominate their own directors to corporate boards. The AFL-CIO and our affiliates have worked closely with the regulatory agencies on a bipartisan basis to ensure that workers' interests as investors are protected through both thoughtful regulation and enforcement.

Although the case for continued reform has never been stronger, powerful corporate interests have been working to attack the investor protections we already have. Their efforts are funded by individuals such as the disgraced former CEO of AIG, Hank Greenberg, and Wilbur Ross, the CEO of the company that owns the infamous Sago coal mine. Through reports by ideological groups, they seek to lower our system of investor protections to the point that companies controlled by the Chinese government can feel safe selling their stock to U.S. investors. They seek to subsidize the jobs of investment bankers by putting at risk the retirement security of millions of America's workers.

In response, the AFL-CIO believes increased accountability and responsibility must be required of our corporations and our capital markets. We call upon the new Congress to begin comprehensive hearings on the continuing failures of our corporate governance and capital market regulation systems. These hearings should address (1) executive pay excesses and the apparent widespread and flagrant legal violations involved in the stock options scandals; (2) the impact of the growth of hedge funds and private equity on the health of our capital markets and our economy overall; (3) the effect that corporate America's retreat from providing pensions has on our system of corporate finance; and (4) the relationship of our increasingly regressive tax system to the explosion in executive pay, our growing budget deficit, and our inability to fund basic governmental obligations.

We call upon Congress and the independent regulatory agencies charged to protect investors to reject calls to weaken investor protections. Our system of investor protection is our competitive advantage in the world capital markets, attracting the foreign capital we require to fund our out-of-control trade deficit.

We call upon Congress to restore full ERISA coverage of hedge funds and to give the Securities and Exchange Commission the clear power to regulate hedge funds as it regulates other forms of money management.

We call upon Congress and the Securities and Exchange Commission to give long-term investors the tools they need to ensure that corporate and mutual fund boards are composed of and led by independent directors ready to hold management accountable to the long-term best interests of public corporations. These tools include the ability of investors to have a voice on executive pay, the requirement that corporate directors have the affirmative support of a majority of the shareholders before they can be elected to a board (majority vote), and a viable method for long-term investors to nominate psychologically independent directors to corporate boards (proxy access).

Testimony
of
Peter J. Wallison
Arthur F. Burns Fellow in Financial Policy Studies
Before the
House Financial Services Committee
March 17, 2009

Summary

In my prepared statement below, I note that giving a government agency the power to designate companies as systemically significant and to regulate their capital and activities is a very troubling idea. For the reasons I outline, it has the potential to destroy competition in every market where a systemically significant company is designated and to fundamentally change the nature of our financial system.

I say this as a person who has spent ten years studying, writing about, and warning that Fannie Mae and Freddie Mac would have a disastrous impact on the financial world, and that ultimately the taxpayers of this country would be required to bail them out.

This wasn't a wild guess on my part. Because they were seen as backed by the government, Fannie and Freddie were relieved of market discipline and able to take risks that other companies could not take. For the same reason, they also had access to lower cost financing than any of their competitors. These benefits enabled them to drive out competition and grow to enormous size. Ultimately, however, the risks they took in exploiting their subsidy caused their collapse and will cause enormous losses for U.S. taxpayers.

When Fannie Mae and Freddie Mac were taken over by the government, they held or had guaranteed $1.6 trillion of subprime and Alt-A mortgages. These loans are defaulting at unprecedented rates, and I believe will ultimately cost U.S. taxpayers $400 billion. That's major league risk-taking.

There is very little difference between a company that has been designated as systemically significant and a GSE like Fannie or Freddie. Almost by definition, a systemically significant firm will not be allowed to fail—because its failure could have systemic effects. As a result, it will seem less risky for creditors and counterparties and will thus be able to borrow money at lower rates than its competitors. This advantage—as we saw with Fannie and Freddie—will allow it to dominate any market it chooses to enter. This is a nightmare for every smaller company in every industry where a systemically significant company operates.

Some will contend that in light of the failures among huge financial firms in recent months only regulation will prevent such things in the future. But this is obviously wrong. Regulation does not prevent risk-taking or loss. Witness the banking industry, the most heavily regulated sector in our economy. Many banks have become insolvent, and many others have been or will be rescued with billions of taxpayer dollars.

On the other hand, as far as I am aware, no taxpayer dollars have been spent to rescue hedge funds, although they are entirely unregulated for safety and soundness.

Extending regulation beyond banking, by picking certain firms and calling them systemically significant, would be a monumental mistake. We will simply be creating an unlimited number of Fannies and Freddies that will haunt our economy in the future.

There are many questions about the idea of systemic risk and regulation. Why choose certain companies as systemically significant? I assume it's because some think that their failure will cause others to fail, and the cascade of losses through the financial system will adversely affect the larger economy.

But is the U.S. banking system in trouble because of the failure of one or more large companies? Of course not. It's in trouble because of pervasive losses on trillions of dollars of bad mortgages. So, will regulation of systemically significant companies prevent a recurrence of a financial crisis in the future? Again, no. Any external shock that causes asset prices to fall precipitously will have the same effect, whether we regulate systemically significant firms or not. And regulation—as with banks—will not even prevent the failure of systemically significant companies. It will only set them up for bailouts when inevitably they suffer losses from their risk-taking.

We cannot prevent external shocks—earthquakes, the political collapse of a major oil producer, a pandemic—and any of these can cause an abrupt decline in global commerce or investors' confidence in the future, either of which can cause a crash in asset prices.

Beyond all this, is it realistic to believe that any agency can set capital ratios for companies as diverse as banks, hedge funds, insurance companies, securities firms, private equity firms, and finance companies? All these firms operate in different ways and compete with one another. Even if some regulator is skilled enough to pick the right capital ratio for every kind of company, will it be able to tell whether a particular product is safe for one kind of company but risky for another? Will it be able to recognize how a change in the capital requirements of the systemically significant firms in one industry sector will affect their competitive effect on all the other industries involved? It is highly doubtful that any systemic regulator will be able to do these things effectively, and no agency, I submit, could do it more effectively than the market.

Finally, the Federal Reserve would be by far the worst choice for systemic regulator. As lender of last resort, it could bail out the companies it is supervising without the approval of Congress or anyone else. Its regulatory responsibilities will conflict with its central banking role, and its involvement with the politics of regulation will destroy its credibility as the nation's monetary authority.

We will achieve nothing by setting up a systemic regulator. If we do it at the cost of destroying faith in the dollar and competition in the financial market, we will have done untold harm to the American economy.

Prepared Statement for the Record

Mr. Chairman and members of the committee: I very much appreciate this opportunity to comment on the issue of systemic regulation and the designation of systemically significant financial institutions. My prepared testimony follows.

Defining Systemically Significant Institutions

Before it considers creating or designating a systemic regulator, especially one that has the authority to designate systemically significant companies, Congress must first agree on a definition of systemic risk and how to identify institutions that might cause or enhance it.

Since the beginning of the financial crisis, there has been increasing attention to the concept of systemic risk. The traditional view of systemic risk is that the failure of a large company will cause the failure of others as its losses cascade through the economy and the financial system. However, the current crisis was not precipitated by the failure of one or more financial institutions. Those failures, which began with Bear Stearns, were the result of an external shock to the financial system: specifically, the sudden recognition among investors that asset-backed securities of various kinds—but especially mortgage-backed securities—were far less safe as investments than their ratings implied. When this occurred in the summer of 2007, the asset-backed securities market suddenly dried up. Funding for portfolios of these securities could not be found, and intermediaries were compelled to sell them at distress prices. The substantially reduced market prices caused the write-down of the same or similar assets on the balance sheets of other financial intermediaries, and the crisis began. Looking at the current financial crisis, accordingly, its origin can be found in the combination of a deflating housing bubble in the United States with an unprecedented number (25 million) of subprime and other nonprime mortgages that were distributed around the world. Secondary causes were poor analysis by rating agencies, low costs for borrowed money, and a mark-to-market accounting system that caused asset values (and hence bank capital) to spiral down as distress sales occurred.

Serious academic papers have referred to this sequence of events as an example of systemic risk—the danger of widespread losses coming from a systemic shock.[1] This may well be true—if we want, we can define systemic risk as the risk of a systemic shock. But this does not mean that we can prevent systemic risk, as so defined, by regulating systemically significant companies. Any number of external shocks—a major earthquake, the political collapse of major oil supplier, a pandemic—can cause investors to lose faith in the future and cause an asset price crash. This kind of systemic risk arises not from the failure of a large institution, or even a small group, but from an exogenous event—a shock to the system—that can come from a potentially infinite number of sources. Regulating systemic risk or systemically significant companies will not have any effect in preventing this from happening, as it would not have prevent the current

[1] Ibid.; see also Philip F. Bartholomew, "Banking Consolidation and Systemic Risk," in *Brookings-Wharton Papers on Financial Services: 2000*, ed. Anthony M. Santomero and Robert E. Litan (Washington, DC: Brookings Institution Press, 2000), 373.

crisis. Meanwhile, however, the regulation of these companies—as I argue below—will raise costs, suppress innovation, and seriously impair competition in every industry where a systemically significant company is designated.

Even if we think of systemic risk in the traditional way—as the result of a cascade of losses coming from the failure of a large and interconnected institution—how would we identify such an institution? One way, of course, is by size, but that is not likely to be sufficient. For example, the interbank payment system is one clear potential source of systemic risk. If one bank in the system were to fail to meet its payment obligations to the others, there could be a cascade of losses as the recipient banks would be unable to meet their own obligations at the end of the day. Within this system, however, relatively small institutions can have outsized effects if they fail to meet their payment obligations; these same institutions are unlikely to be considered systemically significant. In 1974, the failure of Herstatt Bank caused a systemic breakdown, even though no one would have previously considered Herstatt to have been a systemically significant bank.

Finally, what might be considered systemically significant is highly context-specific. Consider the failure of the securities firm Drexel Burnham Lambert in 1990 and the failure of Lehman Brothers in 2008. Drexel was a very large firm in the context of the market at the time, and its failure did not cause any systemic distress; Lehman's failure during the jittery and fragile market that resulted from the wide distribution of poor quality mortgages caused a worldwide freeze-up of interbank lending.

Still, it is possible to argue that regulating large companies that we might designate as systemically significant could prevent these companies from failing and causing losses to other companies in the traditional way that systemic risk has been defined.[2] This is probably the underlying impulse for regulating "systemically significant" companies. The problem, however, is that regulation consistently fails to achieve this objective. We have only to look at the current financial crisis to see the abject failure of regulation in the case of commercial banks. In 1991, the U.S. adopted the Federal Deposit Insurance Corporation Improvement Act (FDICIA), an extremely tough banking law and subsequent regulations, in the wake of the collapse of the S&L industry and the failure of 1600 commercial banks. At that time, as now, members of Congress said that the legislation they were adopting would prevent any future banking crisis. Obviously, it didn't. We are now in the midst of the greatest banking crisis since the Great Depression, and perhaps the greatest of all time. Calling for more regulation is in fact a simple-minded solution—a band-aid—done more to solve Congress's problem (the need to show the public that it is taking *action*) than a clear-eyed response to what is really the issue.

But even if regulation could prevent systemically significant financial institutions from failing, it's not clear why we should want this, and even if we should want to prevent the failure of financial institutions it is also important to consider the costs of doing so. We should keep in mind that we don't really know whether the failure of any financial institution that we might

[2] George G. Kaufman, "Bank Failures, Systemic Risk, and Bank Regulation," *Cato Journal* 16, no. 1 (Spring/Summer 1996): 20.

deem "systemically significant" will have a significant adverse impact on the rest of the economy, or that—if such an effect were to occur—that it could not be handled simply by the Federal Reserve providing some temporary liquidity to the market. If so, we are doing affirmative harm by trying to keep failing institutions alive. Business or financial failure can be the result of bad management or a bad business model. If we preserve failing companies we are saving both. That does not improve the efficiency or quality of our economy or our financial system. Accordingly, if the consequences are not too severe, it would be a better idea to let large institutions fail and take the relatively minor consequences rather than trying to keep them alive.

The Problems of Differential Regulation

But if we still believe that it is worthwhile to regulate systemically significant companies, and that regulation—contrary to all our experience—will actually prevent their failure, we should consider the adverse effects of doing so. One of the most severe of these adverse consequences is the effect on competition of designating certain institutions as systemically significant and thus placing them in a favorable competitive position with respect to their competitors.

Even assuming that we can identify systemically significant institutions, what would be the consequences of regulating them? In my view, designating some companies as systemically significant would have a disastrous effect on the competitive financial system in the United States. This is true because a designation as a systemically significant company is a statement that the government will try to prevent such a company from failing. It is systemically significant because its failure, by hypothesis, will have an adverse effect on the other financial institutions and on the economy as a whole.

In other words, such an institution will be considered too big to fail, and in that respect to have the backing of the government. As we have seen with Fannie Mae and Freddie Mac, an indication that a private firm has the implicit backing of the government—especially if the backing comes from an agency like the Fed, with the power to extend financing—is likely to persuade the markets that loans to this institution would involve less risk than loans to an institution that is operating without this special designation. For this reason, a firm that is designated as systemically significant would be able to raise funds at lower cost than its competitors, would likely be more profitable than its competitors, and would have greater access to capital. Overall, the systemically significant firms would grow larger in relation to others in the same industry and would gradually acquire more and more of their less successful competitors. Eventually, we would see a market much like the housing market that Fannie and Freddie have come to dominate, with a few giant companies, chosen by the government, that have pushed out all competition.

Limitations on a Regulator's Scope of Knowledge

Even if the regulation of systemically significant companies did not have such adverse consequences for our economy and financial system, there is real doubt whether any agency would be able to regulate and supervise systemically significant firms from more than one industry. It goes without saying that banking is a completely different business from insurance,

which is different from securities trading, which, in turn, is different from the risk-taking and arbitrage transactions of hedge funds. The regulation of each company must take account of these differences. In order to decide on such issues as the appropriate amount of capital or leverage for systemically significant companies from different industries and utilizing different business models, the systemic regulator of each company must have a detailed knowledge of the business practices, accounting standards, and taxation of each business model, as well as the competitive environment in which it functions.

Accordingly, in order to be a systemic risk regulator for varied financial industries and business sectors, a regulator would have to acquire a great deal of knowledge and expertise in every field of finance. It would be required to understand how these industries function and why they function the way they do. Every change in capital or leverage would have an effect not only on the competition within the industry in which the particular firm is located, but also on the ability of the firm to compete with other members of the financial services sector. In today's financial services world, banks, insurers, securities firms, hedge funds, mutual funds, finance companies, leasing companies, and even private equity firms compete for business, for capital, and for credit. Any significant mandated change in how the largest firms in each of these financial services industries are able to do business will have an impact—positive or negative—on firms in every other financial services industry.

It is for this reason that the Senate report on the Gramm-Leach-Bliley Act did not give the Fed the authority to supervise the nonbanking subsidiaries of financial holding companies. "It is inefficient and impractical," the report noted, "to expect a regulator to have or to develop expertise in regulating all aspects of financial services."[3] This was the judgment of Congress when securities and insurance were the only activities that were subject to any form of safety-and-soundness regulation (which, in the case of securities firms, was regulation intended primarily to protect customer accounts). If the legislation under consideration ultimately authorizes the Fed (or some other regulator) to supervise every financial intermediary that is systemically significant, it will create a giant regulator that will be required to understand in detail how each of these businesses operates and how a change in the capital, leverage, or business model will affect every other member of the financial services industry.

The underlying theory of a systemic risk regulator is that the agency will not only be able to supervise the systemically significant members of the financial services industry—no matter what business form they take—but will also be able to recognize the development of systemic risks before they place the financial system in jeopardy. Accordingly, not only would the regulator have to be able to forecast the effect of new products and business activities on the future financial health of the particular company and the financial system as a whole, but it will be required to know and apply the best capital level for companies in many different businesses and with many different risk profiles that are adopting or creating new financial products. It must also understand what particular activities or investments present excessive risks when undertaken by such a business. The answers to these questions for hedge funds and insurance companies, for example, are quite different from one another and quite different from those for

[3] *Financial Services Act of 1998*, 105th Cong., 2nd sess., September 18, 1998, S. Rep. 105-336.

banks. Hedge funds are traders and risk-takers; insurance companies are specialists in pooling risks. Hedge funds are financed by equity; insurance companies are generally corporations with capital ratios and long-term assets. Banks are part of a global payment system. Can a single agency make these varied judgments effectively—more effectively than the market itself? This is very doubtful, yet that is what is apparently expected of a single agency that is supposed to regulate and supervise systemically significant companies.

The Federal Reserve as Systemic Risk Regulator

Much of the discussion of the systemic regulator has focused on the Federal Reserve, yet that agency would probably be the worst possible choice to perform this function.

The Fed and Systemic Risk: A Historical Perspective

The Fed has been aware of the concept systemic risk since at least 1998—when the Federal Reserve Bank of New York (with the acquiescence of the Federal Reserve Board) stepped in to prevent the collapse of the hedge fund Long-Term Capital Management (LTCM) when it thought that the collapse would have far-reaching systemic effects. Although the term "systemic risk" is not used in the Bank Holding Company Act of 1970, for the last thirty years the Fed has had all the powers under that act that it might conceivably be given in any legislation in which the Fed is constituted as a systemic regulator. Whether the Fed was correct in stepping in to prevent the default of LTCM will never be known. Many commentators believe it acted precipitously and unnecessarily,[4] but there is no question that the Fed is sensitive to the issue of systemic risk.

The act allows the Fed to regulate bank holding companies (BHCs) in the same way that a bank supervisor can regulate a bank—by regulating their capital and their nonbanking activities and influencing the lending policies of the underlying bank. If the Fed had wanted to control the risk-taking of the largest banks—the institutions most likely to be declared systemically significant—it could have done so through its control over their holding companies. Accordingly, before handing the Fed the power to control systemic risk, Congress should want to know why the Fed has not exercised its existing power to control systemic risk in the banking system—and why it was unable to prevent the near failure of Citibank, the principal subsidiary of Citigroup and an institution that everyone would define as systemically significant. Looked at with hindsight, the Fed failed to perform a useful role as a systemic risk regulator before the current financial crisis, and there is no reason to believe that the agency will be able to do any better with the far more difficult role of regulating the systemic risk of the entire financial system.

Conflicts among the Fed's Roles

[4] See Shadow Financial Regulatory Committee, "The Issues Posed by the Near-Collapse of Long-Term Capital Management," September 28, 1998, available at www.aei.org/docLib/20051114_ShadowStatement151.pdf.

There are inherent conflicts between the role of the Fed as the nation's central bank and its potential role as a regulator of systemically significant companies. As the U.S. central bank, the Fed is responsible for maintaining price stability while fostering economic growth and employment. To a large extent, this role would conflict with the Fed's assignment as a systemic risk regulator. As Robert E. Litan and Charles W. Calomiris noted in a 2000 article: "[W]eakness in the financial sector can tempt a central bank with supervisory authority over financial institutions to pursue a looser monetary policy than it would otherwise follow, imparting an inflationary bias."[5] For example, it might be that at a time of bank weakness, a tight monetary policy would have an adverse effect on the health of the systemically significant financial institutions under the Fed's supervision. Instead of considering the overall health of the economy when it makes its monetary policy decisions, the Fed as bank supervisor or systemic regulator could defer a necessary rate increase in order to reduce the pressure on the institutions it supervises, especially if they were—by definition—too big to fail; they must be kept healthy lest their failure cause an adverse systemic event and resulting criticism of the Fed's regulatory administration. An opposite outcome is also easily imaginable; imagine that the Fed decides not to invoke its power to close down a weak institution because it fears that such an action will then require it to increase market liquidity in order to prevent further financial institution defaults.

Ideally, if there were to be a systemic regulator, it should have the health of the institutions it supervises solely in mind when it makes its decisions. However, the Fed's interest in promoting market stability can lead it to encourage—rather than discourage—risk-taking by the banks it supervises. One example of this phenomenon in action was the Fed's successful effort in 1982 to get various U.S. banks to extend loans to Mexico at a time when Mexico was unable to meet its foreign exchange obligations. Although the banks themselves were threatened by losses on their Mexican loans, they followed the Fed's direction and made new loans to Mexico. At the time, Fed chairman Paul Volcker assured the banks that these risky loans would not be held against them: "[W]here new loans facilitate the adjustment process and enable a country to strengthen its economy and service its international debt in an orderly manner, new credits should not be subject to supervisory criticism."[6] This is not to say that Volcker's decision was wrong in that instance, but only to point out a clear example of the conflict of interest that affects the Fed's administration of its bank regulatory functions.

It is perhaps for this reason that central banks in almost all developed countries have no role other than that of monetary policy. The European Central Bank was established with only a monetary policy role, and only the United States and Israel give their monetary authorities any role in financial system regulation. Elsewhere—Switzerland, Canada, Australia, Germany, Sweden, Spain, the United Kingdom, and Japan, to name just a few—banks are regulated by other government entities. And the trend has been strongly in this direction, with the United

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[5] Charles W. Calomiris and Robert E. Litan, "Financial Regulation in a Global Marketplace," in *Brookings-Wharton Papers on Financial Services: 2000*, ed. Anthony M. Santomero and Robert E. Litan (Washington, DC: Brookings Institution Press, 2000), 292.

[6] Quoted in Bernard Shull, *The Fourth Branch: The Federal Reserve's Unlikely Rise to Power and Influence* (Santa Barbara, CA: Praeger, 2005), 150.

Kingdom, Japan, and Australia having taken bank regulation away from their central banks in recent years.

The traditional position of the Fed has been that its bank regulatory activities assist it in keeping tabs on the economy. The theory is that the examination of banks and reports from banks provide a source of confidential information, not available elsewhere, for judging the health of the overall economy. In reality, however, the Fed does not examine many banks; almost all the large banks are nationally chartered and examined and regulated by the Comptroller of the Currency (OCC). The Fed regulates and supervises BHCs, the companies that control banks. Most of the day-to-day supervisory work on BHCs is done by the regional Federal Reserve banks and not the Federal Reserve Board itself. If necessary, both the OCC and the Federal Deposit Insurance Corporation receive reports from banks and could furnish the confidential information in these reports to the Fed.

Threats to the Independence of Monetary Policy

The Federal Reserve System was designed to be independent of both Congress and the executive branch. The seven members of the Board of Governors of the Federal Reserve System are appointed by the president for fourteen-year staggered terms—by far the longest in the federal government—and the agency is independent of the congressional appropriations process. The chairman is appointed by the president for a four-year term, but his term is not coextensive with the election of the president, so that the Fed chair remains in office for at least the first two years of the new president's term.

This extraordinary insulation from the elected branches gives the Fed credibility with the financial markets, which are justifiably concerned that the Fed's policies on price stability will eventually start to follow election returns, allowing the dollar to devalue for political rather than economic reasons. As Laurence Meyer, a former Fed governor, observed: "The motivation for granting independence to central banks is to insulate the conduct of monetary policy from political interference, especially interference motivated by the pressures of elections to deliver short-term gains irrespective of longer-term costs . . . [and] to provide a credible commitment of the government, through its central bank, to achieve . . . price stability."[7]

The Fed's independence has spawned a great deal of controversy, as it should in a democracy. The question is whether an organization that has the power to affect the economy in such substantial ways—resulting in more growth or less in both the economy and employment—should be able to function without accountability to the elected branches. The agency's independence has been repeatedly challenged by powerful members of Congress, usually when it tightens monetary policy and suppresses economic growth in the interest of maintaining stable prices.

[7] Laurence H. Meyer, "The Politics of Monetary Policy: Balancing Independence and Accountability" (speech, University of Wisconsin, La Crosse, WI, October 24, 2000), available at www.federalreserve.gov/BOARDDOCS/SPEECHES/2000/20001024.htm (accessed February 20, 2009).

This conflict springs from important political interests. Price stability—that is, a stable currency value—favors lenders; inflation in currency values favors borrowers because they are able to repay their loans with inflated dollars. The tribunes of the common man, like William Jennings Bryan, opposed the "cross of gold" because they saw the tight money policies implied by the gold standard as a burden on the working man (now called "working families"). This controversy continues into the modern era. In 1989, for example, then-representatives Lee Hamilton (D-Ind.) and Byron Dorgan (D-N.D.) introduced legislation intended to make the Fed "more accountable" for its decisions, a move described as follows in the *New York Times*: "The Midwestern farmers and businessmen whom Mr. Hamilton and [Mr. Dorgan] represent often favor lower interest rates or 'easy money' to make borrowing easier. . . . But the Federal Reserve has traditionally agreed with bankers and bond dealers, who typically advocate 'hard money,' or higher rates, to prevent the inflation that can devalue the loans they make and the securities in which they deal."[8]

Today, the question of the Fed's independence revolves around the credibility of its policies. For the past twenty-five years, with the exception of a few years after the dot-com collapse in the early 2000s and current efforts to address the financial crisis, the Fed has followed a policy of keeping inflation low by controlling the money supply or otherwise attempting to limit price increases. This has resulted in a slow rate of inflation (1 or 2 percent a year) and relatively stable long-term interest rates. Long-term rates, which are essential for investment planning by business, will remain stable as long as the credit markets believe that the Fed will continue to follow a stable price policy in the future. In the late 1970s, the Fed's commitment to price stability had lost credibility, and long-term rates rose to historic highs. It took several years of painful Fed money supply management—and high unemployment—to win back the credibility that was required to bring these rates down.

The credit markets understand that the political pressures in a democracy favor inflation—there are simply many more borrowers than lenders—and so they watch carefully to determine if the Fed is buckling under pressure from Congress and the president. Thus, while the Fed's independence is inconsistent with democracy, it reflects a practical judgment that the nation's economy would be better off if its monetary policy is determined independently and objectively by economic rather than political considerations. A similar judgment, as noted above, has been made in many other major developed countries. Indeed, at least one study has shown that in countries where the central bank is also engaged in bank regulation, inflation rates tend to be higher.[9] This is what would be expected if the central bank is under pressure to put off credit-tightening in order to make sure that the banks it supervises are stable.

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[8] 10. Louis Uchitelle, "Moves On in Congress to Lift Secrecy at the Federal Reserve," *New York Times*, August 24, 1989.

[9] Carmine Di Noia and Giorgio Di Giorgio, "Should Banking Supervision and Monetary Policy Tasks Be Given to Different Agencies?" (Working Paper 411, Department of Economics and Business, Universitat Pompeu Fabra, Barcelona, October 19, 1999), 8, available at www.econ.upf.edu/docs/papers/downloads/411.pdf (accessed February 19, 2009).

Nevertheless, the cooperation between the Fed and the Treasury in the last year has been unprecedented, which raises serious questions about the Fed's long-term independence from the elected branches and hence the credibility of its stable price policies. When the crisis comes to an end, this will surely be one of the major issues that the financial markets will worry about. Will the Fed simply have become an arm of the Treasury Department, or will it be able to separate itself in the future from Treasury policies that it has had a major role in creating and implementing? Will the Fed sop up the liquidity that it has poured into the economy, or will it again cooperate with the Treasury at least through the election of 2012?

It is through this lens that the Fed's power over systemically significant companies should be viewed. Giving the Fed the power to regulate all the key financial firms in the U.S. economy would involve the agency in major decisions about how business is carried out by whole industries. Unlike monetary policy—which depends for its success on the financial markets' belief that the Fed is making its decisions on the basis of economic rather than political factors—there is no practical or policy basis for insulating the Fed's control over systemically significant companies from political influence. These decisions are clearly important enough that they should be subject to political influence.

Fortunately, there seems to be some recognition of the importance of this issue on the part of Senate Banking Committee chairman Christopher Dodd (D-Conn.). At a hearing on regulatory reform on February 4, 2009, Dodd noted the danger associated with giving the Fed a major regulatory role: "We must be mindful of ensuring the independence and integrity of the Fed's monetary policy function."[10] In the same hearing, former Fed chairman Volcker was asked about the broad authority some have talked about giving to the Fed. In response, he pointed out that there are dangers in loading up the Fed with responsibilities: "You will have a different Federal Reserve if the Federal Reserve is going to do all the regulation from a prudential standpoint. . . . You have to consider whether that's a wise thing to do when their primary responsibility is monetary policy."[11]

Use of the Discount Window

The Fed has one authority that no other regulator possesses—the ability to create and lend money without an appropriation from Congress. The flexibility of the Fed's authority as lender of last resort has been demonstrated in the current financial crisis by the agency's willingness to lend on an emergency basis to companies and organizations that are not banks or BHCs. The continued availability of this authority raises troubling questions if the Fed is to become the regulator of all systemically significant financial institutions, because it will institutionalize a substantial broadening of the Fed's lender-of-last-resort functions. The underlying reason for regulating systemically significant firms is concern that their failure will

[10] Christopher Dodd, "Modernizing the U.S. Financial Regulatory System" (remarks, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 4, 2009), available at http://dodd.senate.gov/?q=node/4752 (accessed February 19, 2009).

[11] Quoted in Steven Sloan, "Dodd Voicing Doubt on Fed Systemic Role," *American Banker*, February 5, 2009.

cause failures elsewhere in the economy—that is why they are called "systemically significant." Under these circumstances, giving the Fed authority to regulate and supervise these firms is essentially the same thing as giving it authority to use its lender-of-last-resort facility to provide them with the liquidity necessary to prevent their failure. The effect, of course, will be to extend the Fed's safety net far beyond the banking industry.

The Group of Thirty report contains a recommendation that, in whatever form regulation might take, it should preserve the restriction in current law that prevents the commercial firms from acquiring control of insured depository institutions.[12] The longstanding reason for the separation of banking and commerce has been a fear (wholly unwarranted, in my view) that if commercial firms were to control banks, the government safety net—which includes the Fed's discount window lending facility—would be spread beyond the banking industry. Yet the designation of the Fed as the systemic risk regulator—with authority to cover many institutions other than banks—would do just that. In addition, it raises questions whether—to protect the safety net—there should be restrictions on commercial companies owning financial institutions other than banks. For this reason, if any agency were to be given authority to regulate all systemically significant firms, the Fed should be the last agency on the list.

Conclusion

The case for creating a systemic risk regulator has not been made. There is no clear definition of systemic risk, and specially supervising companies arbitrarily designated as systemically significant would seriously disrupt competition in every field in which a systemically significant company operates. In addition, it is highly doubtful that any agency would be able to assemble and implement regulatory and supervisory policies that would entail setting capital levels and risk standards for companies as diverse as banks, insurance companies, hedge funds, finance companies, securities firms and private equity groups—all of which compete with one another. Finally, even if it were possible to identify systemically significant companies, and to overcome the competitive problems such a policy would entail, the Federal Reserve would be a very poor choice for the systemic supervisor. Such an assignment for the Fed would create significant conflicts with its monetary policy role and impair the independence that the agency needs to carry out that role effectively.

[12] See Peter J. Wallison, "Regulation without Reason: The Group of Thirty Report."

March 17, 2009

Testimony of

Edward L. Yingling

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

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Chairman Frank, Ranking Member Bachus, and members of the Committee, my name is Edward L. Yingling. I am President and CEO of the American Bankers Association (ABA). ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members -- the majority of which are banks with less than $125 million in assets -- represent over 95 percent of the industry's $13.9 trillion in assets and employ over 2.2 million men and women.

The ABA congratulates the Committee on the approach it is taking to respond to the financial crisis. There is a great need to act, but to do so in a thoughtful and thorough manner, and with the right priorities. That is what this Committee is doing. On March 10, Federal Reserve Board Chairman Bernanke gave an important speech laying out his thoughts on regulatory reform. He laid out an outline of what needs to be addressed in the near term and why, along with general recommendations. We are in broad agreement with the points Chairman Bernanke made in that speech.

Chairman Bernanke focused on three main areas: first, the need for a systemic regulator; second, the need for a pre-existing method for an orderly resolution of a systemically important non-bank financial firm; and third, the need to address gaps in our regulatory system. Statements by the leadership of this Committee have also focused on a legislative plan to address these three areas. We agree that these three issues – a systemic regulator, a new resolution mechanism, and addressing gaps -- should be the priorities. This terrible crisis should not be allowed to happen again, and addressing these three areas is critical to making sure it does not.

The ABA strongly supports the creation of a systemic regulator. In retrospect, it is inexplicable that we have not had a regulator that has the explicit mandate and the needed authority to anticipate, identify, and correct, where appropriate, systemic problems.

To use a simple analogy, think of the systemic regulator as sitting on top of Mount Olympus looking out over all the land. From that highest point the regulator is charged with surveying the land, looking for fires. Instead, we have had a number of regulators, each of which sits on top of a smaller mountain and only sees its part of the land. Even worse, no one is effectively looking over some areas.

This needs to be addressed. While there are various proposals as to who should be the systemic regulator, most of the focus has been on giving the authority to the Federal Reserve. It does make sense to look for the answer within the parameters of the current regulatory system. It is doubtful that we have the luxury, in the midst of this crisis, to build a new system from scratch, however appealing that might be in theory. There are good arguments for looking to the Federal Reserve, as outlined in the Bernanke speech. This could be done by giving the authority to the Federal Reserve or by creating an oversight committee chaired by the Federal Reserve. ABA's concern in this area relates to what it may mean for the independence of the Federal Reserve in the future. We strongly believe that Federal Reserve independence in setting monetary policy is of utmost importance.

ABA believes that systemic regulation cannot be effective if accounting policy is not part of the equation. That is why we support the Perlmutter/Lucas bill, H.R. 1349. To continue my analogy, the systemic regulator on Mount Olympus cannot function if part of the land is held strictly off limits and under the rule of some other body that can act in a way that contradicts the systemic regulator's policies. That is, in fact, exactly what happened with mark-to-market accounting.

I want to take this opportunity to thank this Committee for the bipartisan efforts in the hearing last week on mark-to-market. Your action can significantly aid in the economic recovery. We must hope that the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) will take the comprehensive action you clearly advocated.

As Chairman Bernanke pointed out, as part of a systemic approach, the Federal Reserve should be given comprehensive regulatory authority over the payments system, broadly defined.

ABA agrees. We should not run the risk of a systemic implosion instigated by gaps in payment system regulations.

ABA also strongly supports creating a mechanism for the orderly resolution of systemically important non-bank firms. Our regulatory bodies should never again be in the position of making up a solution on the fly to a Bear Stearns or AIG, of not being able to solve a Lehman Brothers. The inability to deal with those situations in a predetermined way greatly exacerbated the crisis. Indeed, many experts believe the Lehman Brothers failure was the event that greatly accelerated the crisis. We believe that existing models for resolving troubled or failed institutions provide an appropriate starting point – particularly the FDIC model, but also the more recent handling of Fannie Mae and Freddie Mac.

A critical issue in this regard is too-big-to-fail. Whatever is done on the systemic regulator and on a resolution system will set the parameters of too-big-to-fail. In an ideal world, no institution would be too big to fail, and that is ABA's goal; but we all know how difficult that is to accomplish, particularly with the events of the last few months. This too-big-to-fail concept has profound moral hazard implications and competitive effects that are very important to address. We note Chairman Bernanke's statement: "Improved resolution procedures...would help reduce the too-big-to-fail problem by narrowing the range of circumstances that might be expected to prompt government action...."[1]

The third area for focus is where there are gaps in regulation. These gaps have proven to be major factors in the crisis, particularly the role of largely unregulated mortgage lenders. Credit default swaps and hedge funds also should be addressed in legislation to close gaps.

There seems to be a broad consensus to address these three areas. The specifics will be complex and, in some cases, contentious. But at this very important time, with Americans losing their jobs, their homes, and their retirement savings, all of us should work together to develop a stronger regulatory structure. The ABA pledges to be an active and constructive participant in this critical effort.

In fact, even before the turmoil of last fall, ABA's board of directors recognized this need to address the difficult questions about regulatory reform and the desirability of a systemic risk regulator. As a consequence, Brad Rock, ABA's chairman at that time, and chairman, president, and

[1] Ben Bernanke, speech to the Council on Foreign Relations, Washington, D.C. , March 10, 2009.

CEO of Bank of Smithtown, Smithtown, New York, appointed a task force to develop principles and recommendations for change. I will highlight many of the principles developed by this group – and adopted by ABA's board of directors – throughout my statement today.

In the rest of my statement today, I would like to expand on the priorities for change:

- ***Establish a regulatory structure that provides a mechanism to oversee and address systemic risks.*** Included under this authority is the ability to mitigate risk-taking from systemically important institutions, authority over how accounting rules are developed and applied, and protections to maintain the integrity of the payments system.

- ***Establish a method to handle the failure of non-bank institutions that threaten systemic risk.***

- ***Close the gaps in regulation.*** This might include the regulation of hedge funds, credit default swaps, and particularly non-bank mortgage brokers.

I would like to touch briefly on each of these priorities to highlight issues that underlie them.

I. Establish a Regulatory Structure That Provides a Mechanism to Oversee and Address Systemic Risks

As I have said in other hearings before this Committee, ABA supports the formation of a systemic risk regulator. There are many aspects to consider related to the authority of this regulator, including the ability to mitigate risk-taking from systemically important institutions, authority over how accounting rules are developed and applied, and the protections needed to maintain the integrity of the payments system. I will discuss and highlight ABA's guiding principles on each of these.

A. There is a need for a regulator with explicit systemic risk responsibility.

A systemic risk regulator would strengthen the financial infrastructure. As Chairman Bernanke noted: "[I]t would help make the financial system as a whole better able to withstand future shocks, but also to mitigate moral hazard and the problems of too big to fail by reducing the range of circumstances in which systemic stability concerns might prompt government intervention." ABA believes the following principles should apply to any systemic risk regulator:

- **Systemic risk oversight should utilize existing regulatory structures to the maximum extent possible and involve a limited number of large market participants, both bank and non-bank.**

- **The primary responsibility of the systemic risk regulator should be to protect the economy from major shocks. The systemic risk regulator should pursue this objective by gathering information, monitoring exposures throughout the system and taking action in coordination with other domestic and international supervisors to reduce the risk of shocks to the economy.**

- **The systemic risk regulator should work with supervisors to avoid pro-cyclical reactions and directives in the supervisory process.**

- **There should *not* be a new consumer regulator for financial institutions. Safety and soundness implications, financial risk, consumer protection, and other relevant issues need to be considered together by the regulator of each institution.**

It is clear we need a systemic regulator that looks across the economy and identifies problems. To fulfill that role, the systemic regulator would need broad access to information. It may well make sense to have that same regulator have necessary powers, alone or in conjunction with the Treasury, and a set of tools to address major systemic problems. (Although based on the precedents set over the past few months, it is clear that those tools are already very broad.)

At this point, there seems to be a strong feeling that the Federal Reserve should take on this role in a more robust, explicit fashion. That may well make sense, as the Federal Reserve has been generally thought to be looking over the economy. We are concerned, however, that any expansion of the role of the Federal Reserve could interfere with the independence required when setting monetary policy. One of the great strengths of our economic infrastructure has been our independent Federal Reserve. We urge Congress to carefully consider the long-term impact of

changes in the role of the Federal Reserve and the potential for undermining its effectiveness on monetary policy.

Thus, the ABA offers these guiding principles:

- **An independent central bank is essential.**
- **The Federal Reserve's primary focus should be the conduct of monetary policy.**

B. To be effective, the systemic risk regulator must have some authority over the development and implementation of accounting rules.

Accounting standards are not only measurements designed to ensure accurate financial reporting, but they also have an increasingly profound impact on the financial system – so profound that they must now be part of any systemic risk calculation. No systemic risk regulator can do its job if it cannot have some input into accounting standards – standards that have the potential to undermine any action taken by a systemic regulator. Thus, a new system for the establishment of accounting rules – one that considers the real-world effects of accounting rules – needs to be created in recognition of the critical importance of accounting rules to systemic risk and economic activity. Thus, ABA sets forth the following principles to guide the development of a new system:

- **The setting of accounting standards needs to be strengthened and expanded to include oversight from the regulators responsible for systemic risk.**
- **Accounting should be a reflection of economic reality, not a driver.**
- **Accounting rules, such as loan-loss reserves and fair value accounting, should minimize pro-cyclical effects that reinforce booms and busts.**
- **Clearer guidance is urgently needed on the use of judgment and alternative methods, such as estimating discounted cash flows when determining fair value in cases where asset markets are not functioning and for recording impairment based on expectations of loss.**

Again, I want to commend the bipartisan efforts of this Committee in the hearing last week on mark-to-market. Your action can significantly aid in the economic recovery. The ABA particularly thanks subcommittee chairman Rep. Paul E. Kanjorski (PA) and ranking Republican subcommittee member Rep. Scott Garrett (NJ) for their leadership. For several years, long before the current downturn, ABA argued that mark-to-market was pro-cyclical and should not be the model used for financial institutions as required by the Financial Accounting Standards Board (FASB). Even now, the FASB's stated goal is to continue to expand the use of mark to market accounting for all financial instruments. For months, we have specifically asked FASB to address the problem of marking assets to markets that were dysfunctional.

Our voice has been joined by more and more people who have been calling for FASB and the Securities and Exchange Commission to address this issue, including Federal Reserve Chairman Bernanke and, as noted below, former Federal Reserve Chairman Paul Volcker. For example, in his recent speech, Chairman Bernanke stated: "[R]eview of accounting standards governing valuation and loss provisioning would be useful, and might result in modifications to the accounting rules that reduce their procyclical effects without compromising the goals of disclosure and transparency."[2] Action is needed, and quickly, so that first quarter reports can be better aligned with economic realities. We hope that FASB and SEC will take the significant action that is needed; this is not the time to merely tinker with the current rules.

In creating a new oversight structure for accounting, independence from outside influence should be an important component, as should the critical role in the capital markets of ensuring that accounting standards result in financial reporting that is credible and transparent. But accounting policy can no longer be divorced from its impact; the results on the economy and on the financial system must be considered. That is why we support the Perlmutter/Lucas bill, H.R. 1349, which would create a board to stand in the place currently held by the SEC.

This board would also examine issues such as whether the FASB rules result in international competitiveness concerns. Issues such as recognition of "other than temporary impairment" (OTTI), which in this environment is critically important as U.S. accounting rules generally result in higher losses than the international accounting rules, placing U.S. companies at a disadvantage. Therefore, we are very much in agreement with the recommendations of Group of 30, headed by

[2] Ibid

Paul Volcker and Jacob Frenkel on fair value accounting in its *Financial Reform: A Framework for Financial Stability.* That report stated: "The tension between the business purpose served by regulated financial institutions that intermediate credit and liquidity risk and the interests of investors and creditors should be resolved by development of principles-based standards that better reflect the business model of these institutions…." The Group of 30 suggests that accounting standards be reviewed:

(1) to develop "more realistic guidelines for dealing with less-liquid instruments and distressed markets";

(2) by "prudential regulators to ensure application in a fashion consistent with safe and sound operation of [financial] institutions"; and

(3) to be more flexible "in regard to the prudential need for regulated institutions to maintain adequate credit-loss reserves".

The oversight board created by H.R. 1349 would be in the ideal position to accomplish these recommendations.

C. Uniform standards are needed to maintain the reliability of the payments system.

An important part of the conduct of monetary policy is the reliability of the payments system, including the efficiency, security, and integrity of the payments system. Therefore, ABA offers these three principles:

- **The Federal Reserve should have the duty to set the standards for the reliability of the payments system, and have a leading role in the oversight of the efficiency, integrity, and security thereof.**

- **Reforms of the payments system must recognize that merchants and merchant payment processors have been the source of the largest number of abuses and lost customer information. All parts of the payments system must be responsible for its reliability.**

- **Assuring the integrity of the payments system against financial crime and abuse should be an integral part of the supervisory structure that oversees system reliability.**

Banks have long been the primary players in the payments system ensuring safe, secure, and efficient funds transfers for consumers and businesses. Banks are subject to a well-defined regulatory structure and are examined to ensure compliance with the standards. Unfortunately, the current regulatory scheme does not apply comparable standards for non-banks that participate in the payments system. This is a significant gap that needs to be filled.

In recent years, non-banks have begun offering "non-traditional" payment services in greater numbers. Internet technological advances combined with the increase in consumer access to the Internet have contributed to growth in these alternative payment options. These activities introduce new risks to the system. Another key difference between banks and non-banks in the payments system is the level of protection granted to consumers in case of a failure to perform. It is important to know the level of capital held by a payment provider where funds are held, and what the effect of a failure would be on customers using the service. This information is not always as apparent as it might be.

The non-banks are not subject to the same standards of performance and financial soundness as banks, nor are they subject to regular examinations to ensure the reliability of their payments operations. In other words, this is yet another gap in our regulatory structure, and one that is growing. This imbalance in standards becomes a competitive problem when customers do not recognize the difference between banks and non-banks when seeking payment services.

In addition, the current standard designed to provide security to the retail payment system, the Payment Card Industry Data Security Standard, compels merchants and merchant payment processors to implement important information security controls, yet tends to be checklist and point-in-time driven, as opposed to the risk-based approach to information security required of banks pursuant to the Gramm-Leach-Bliley Act.[3] Through the Bank Service Company Act, federal bank regulatory agencies can examine larger core payment processors and other technology service providers for GLB compliance.[4] We would encourage the Federal Reserve to use this power more aggressively going forward, and examine an increased number of payment processors and other technology providers.

In order to ensure that consumers are protected from financial, reputational, and systemic risk, all banks and non-bank entities providing significant payment services should be subject to

[3] 16 CFR 314
[4] 12 USC 1861-1867(c)

similar standards. This is particularly important for the operation of the payments system, where uninterrupted flow of funds is expected and relied upon by customers. Thus, ABA believes that the Federal Reserve should develop standards for reliability of the payments system that would apply to all payments services providers, comparable to the standards that today apply to payments services provided by banks. The Federal Reserve should review its own authority to supervise non-bank service providers in the payments system and should request from Congress those legislative changes that may be needed to clarify the authority of the Federal Reserve to apply comparable standards for all payments system providers. We support the statement made by Chairman Bernanke: "Given how important robust payment and settlement systems are to financial stability, a good case can be made for granting the Federal Reserve explicit oversight authority for systemically important payment and settlement systems."[5]

II. *Establish a Method to Handle the Failure of Non-bank Institutions That Threaten Systemic Risk*

We fully agree with Chairman Bernanke when he said: "[T]he United States also needs improved tools to allow the orderly resolution of a systemically important nonbank financial firm, including a mechanism to cover the costs of the resolution."[6] Recent government actions have clearly demonstrated a policy to treat certain financial institutions as if they were too big or too complex to fail. Such a policy can have serious competitive consequences for the banking industry as a whole. Without accepting the inevitability of such a policy, clear actions must be taken to address and ameliorate negative consequences of such a policy, including efforts to strengthen the competitive position of banks of all sizes.

The current ad hoc approach, used with Bear Stearns and Lehman Brothers, has led to significant unintended consequences and needs to be replaced with a concrete, well-understood method of resolution. There is such a system for banks, and that system can serve as a model. However, the system for banks is based in an elaborate system of bank regulation and the bank safety net. The system for non-banks should not extend the safety net, but rather should provide a mechanism for failure designed to limit contagion of problems in the financial system.

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[5] Ibid
[6] Ibid

Thus, the ABA offers several principles to guide this discussion:

- **Financial regulators should develop a program to watch for, monitor, and respond effectively to market developments relating to perceptions of institutions being too big or too complex to fail—particularly in times of financial stress.**

- **Specific authorities and programs must be developed that allow for the orderly transition of the operations of any systemically significant financial institution.**

The creation of a systemic regulator and of a mechanism for addressing the resolution of entities, of course, raises the important and difficult question of what institutions should be considered systemically important, or in other terms, too-big-to-fail. The theory of too-big-to-fail (TBTF) has in this crisis been expanded to include institutions that are too intertwined with other important institutions to be allowed to fail. We agree with Chairman Bernanke when he said that the "clear guidelines must define which firms could be subject to the alternative [resolution] regime and the process for invoking that regime."[7]

I was very involved, from the private-sector side, during the debate and adoption several years ago of what is now called the systemic risk exception. During that debate, the ABA sought the tightest possible language for the systemic risk exception. Basically, we wanted to limit the TBTF concept as much as possible.

We did this for two reasons, reasons that still apply today: first, TBTF presents the classic moral hazard problem – it can encourage excess risk-taking by an entity because the government will not allow it to fail; second, TBTF presents profound competitive fairness issues – TBTF entities will have an advantage – particularly in funding, through deposits and otherwise – over institutions that are ***not*** too big to fail.

Our country has now stretched the systemic risk exception beyond what could have been anticipated when it was created. In fact, we have gone well beyond its application to banks, as we have made non-banks TBTF. Ideally, we would go back and strictly limit its application, but that may not be possible. Therefore, we need to adopt a series of policies that will address the moral hazard and unfair competition issues while protecting our financial system and the taxpayers. This may be the most difficult question Congress will face as it reforms our financial system.

[7] Ibid

For one thing, this cannot be done in isolation from what is being done in other countries. Systemic risk clearly does not stop at the border. In addition, the ability to compete internationally will be a continuing factor in designing and evolving our regulatory system. Our largest financial institutions compete around the world, and many foreign institutions have a large presence in the United States.

This is also a huge issue for the thousands of U.S. banks that will not be considered too big to fail. As ABA has noted on many occasions, these are institutions that never made a subprime loan, are well capitalized, and are lending. Yet they have been deeply and negatively affected by this crisis – a crisis caused primarily by less regulated or unregulated entities like mortgage brokers and by Wall Street firms. These banks have seen their name "banks" sullied as it is used very broadly; they have seen their local economies hurt, and sometimes devastated, which led to loan losses; and they have seen their deposit insurance premiums drastically increased to pay for the excessive risk-taking of institutions that have failed. At the same time, there is a clear unfairness in that many depositors believe their funds, above the insurance limit, are safer in a TBTF institution than other banks. And, in fact, this notion is reinforced when large uninsured depositors lose money – take a "haircut" – when the FDIC closes some not-too-big-to fail banks.

There are many difficult questions. How will a determination be made that an institution is systemically important? When will it be made? What extra regulations will apply? Will additional capital and risk management requirements be imposed? How will management issues be addressed? Some have argued that the largest, most complex institutions are too big to manage. Which activities will be put off-limits and which will require special treatment, such as extra capital to protect against losses? How do we avoid another AIG situation, where, it is widely agreed, what amounted to a risky hedge fund was attached to a strong insurance company and brought the whole entity down? And, importantly, how do we make sure we maintain the highly diversified financial system that is unique to the United States?

III. Close the Gaps in Regulation

A major cause of our current problems is the regulatory gaps that allowed some entities to completely escape effective regulation. It is now apparent to everyone that a critical gap occurred with respect to the lack of regulation of independent mortgage brokers. Questions are also being raised with respect to credit derivatives, hedge funds, and others.

Given the causes of the current problem, there has been a logical move to begin applying more bank-like regulation to the less-regulated and un-regulated parts of the financial system. For example, when certain securities firms were granted access to the discount window, they were quickly subjected to bank-like leverage and capital requirements. Moreover, as regulatory change points more toward the banking model, so too has the marketplace. The biggest example, of course, is the movement of Goldman Sachs and Morgan Stanley to Federal Reserve holding company regulation.

As these gaps are being addressed, Congress should be careful not to impose new, unnecessary regulations on the traditional banking sector, which was not the source of the crisis and continues to provide credit. Thousands of banks of all sizes, in communities across the country, are scared to death that their already-crushing regulatory burdens will be increased dramatically by regulations aimed primarily at their less-regulated or unregulated competitors. Even worse, the new regulations will be lightly applied to non-banks while they will be rigorously applied – down to the last comma – to banks.

This committee has worked hard in recent years to temper the impact of regulation on banks. You have passed bills to remove unnecessary regulation, and you have made existing regulation more efficient and less costly. As you contemplate major changes in regulation – and change is needed – ABA would urge you to ask this simple question: how will this change impact those thousands of banks that make the loans needed to get our economy moving again?

There are so many issues related to closing the regulatory gaps that it would be impossible to cover each in detail in this statement. Therefore, let me summarize the important issues by providing the key principles that should guide any discussion about filling the regulatory gaps:

- **The current system of bank regulators has many advantages. These advantages should be preserved as the system is enhanced to address systemic risk and non-bank resolutions.**

- Regulatory restructuring should incorporate systemic checks and balances among equals and a federalist system that respects the jurisdictions of state and federal powers. These are essential elements of American law and governance.
- We support the roles of the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), Federal Reserve, the Office of Thrift Supervision (OTS) and the state banking commissioners with regard to their diverse responsibilities and charters within the U.S. banking system.
- Bank regulators should focus on bank supervision. They should not be in the business of running banks or managing bank assets and liabilities.

➢ **The dual banking system is essential to promote an efficient and competitive banking sector.**

- The role of the dual banking system as incubator for advancements in products and services, such as NOW and checking accounts, is vital to the continued evolution of the U.S. banking sector.
- Close coordination between federal bank regulators and state banking commissioners within Federal Financial Institutions Examination Council (FFIEC) as well as during joint bank examinations is an essential and dynamic element of the dual banking system.

➢ **Charter choice and choice of ownership structure are essential to a dynamic, innovative banking sector that responds to changing consumer needs, customer preferences, and economic conditions.**

- Choice of charter and form of ownership should be fully protected.
- ABA strongly opposes charter consolidation. Unlike the flexibility and business options available under charter choice, a consolidated universal charter would be unlikely to serve evolving customer needs or encourage market innovation.
- Diversity of ownership, including S corporations, limited liability corporations, mutual ownership, and other forms of privately held and publicly traded banks, should be strengthened.

➢ **Diversity of business models is a distinctive feature of American banking that should be fostered.**

- Full and fair competition within a robust banking sector requires a diversity of participants of all sizes and business models with comparable banking powers and appropriate oversight.

- Community banks, development banks, and niche-focused financial institutions are vital components of the financial services sector.
- A housing-focused banking system based on time-tested underwriting practices and disciplined borrower qualification is essential to sustained homeownership and community development.

➢ **An optional federal insurance charter should be created.**

➢ **Similar activities should be subject to similar regulation and capital requirements. These regulations and requirements should minimize pro-cyclical effects.**

- Consumer confidence in the financial sector as a whole suffers when non-bank actors offer bank-like services while operating under substandard guidelines for safety and soundness.
- Credit unions that act like banks should be required to convert to a bank charter.
- Capital requirements should be universally and consistently applied to all institutions offering bank-like products and services.
- Credit default swaps and other products that pose potential systemic risk should be subject to supervision and oversight that increase transparency, without unduly limiting innovation and the operation of markets.
- Where possible, regulations should avoid adding burdens during times of stress. Thus, for instance, deposit insurance premium rates need to reflect a balance between the need to strengthen the fund and the need of banks to have funds available to meet the credit needs of their communities in the midst of an economic downturn.

➢ **The FDIC should remain focused on its primary mission of assuring the safety of insured deposits.**

- The FDIC plays a crucial role in maintaining the stability and public confidence in the nation's financial system by insuring deposits, and in conducting activities directly related to that mission, including examination and supervision of financial institutions as well as managing receiverships and assets of failed banking institutions so as to minimize the costs to FDIC resources.

➢ **To coordinate anti-money laundering oversight and compliance, a Bank Secrecy Act "gatekeeper," independent from law enforcement and with a nexus to the payments system, should be incorporated into the financial regulatory structure.**

Conclusion

Thank you for the opportunity to present the views of ABA on the regulation of systemic risk and restructuring of the financial services marketplace. The financial turmoil over the last year, and particularly the protection provided to institutions deemed to be "systemically important," require a system that will more efficiently and effectively prevent such problems from arising in the first place and a procedure to deal with any problems that do arise. Clearly, it is time to make changes in the financial regulatory structure. We hope that the principles laid out in this statement will help guide the discussion. We look forward to working with Congress to address needed changes in a timely fashion, while maintaining the critical role of our nation's banks.

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