

Statement by Christopher Whalen
Committee on Banking, Housing and Urban Affairs
United States Senate
March 24, 2009

Chairman Dodd, Senator Shelby, Members of the Committee:

My name is Christopher Whalen and I live in the State of New York.¹ Thank you for requesting my testimony today regarding “Modernizing Bank Supervision and Regulation.”

Before I address the areas that you have specified, let me suggest some broad themes and questions for further investigation, questions which I believe the Committee should consider before diving into the detail of actual legislative changes to current law and regulation. Simply stated, we need to do some basic diligence about our financial institutions, our markets and our economy, both generally and with respect to the present financial crisis, before we can attack the task of remaking the current supervision and regulation of financial institutions.

Financial Institutions Structure

- What is a financial institution in terms of the reality today in the marketplace vs. the stated intent of law and regulation? What tasks do financial institutions perform that actually require public regulation? What tasks do not?
- What activities should be permitted for federally insured depositories? What capital is required to support these regulated activities in a safe and sound manner?
- How much capital must an insured depository institution have in order for a) markets and b) the public to have confidence in that institution’s ability to function? Are regulatory measures even meaningful to the public today?
- How do regulatory regimes such as fair-value accounting and Basel II, and market-driven measures such as EBITDA or tangible common equity (“TCE”), affect the real and perceived need for more capital in financial institutions? Is the marketplace a better arbiter of capital adequacy, particularly from a public interest perspective, than the private internal bank models and equally inconsistent, non-public regulatory process enshrined in the Basel II accord?

¹ Mr. Whalen is a co-founder of [Institutional Risk Analytics](#), a Los Angeles unit of Lord, Whalen LLC that publishes risk ratings and provides customized financial analysis and valuation tools.

Financial Market Structure

- What is “systemic risk?” Is systemic risk a symptom of other risk factors or an independent risk measure in and of itself? If the latter, how is it measured?²
- How do government policies either increase or decrease systemic risk? For example, has the growth of Over-the-Counter (“OTC”) market structures increased perceived systemic risk hurt investors and negatively affected the safety and soundness of financial markets?
- Does the fact of cash settlement for credit default contracts increase system leverage and therefore risk? Does the rescue of AIG illustrate how OTC cash settlement credit default contracts multiply the systemic risk of a given cash market credit basis?³
- Should the Congress mandate SEC registration for all investment instruments that are eligible for investment by smaller banks, insurers, pensions and public agencies? Should the Congress place limits on the ability of securities dealers to sell complex OTC structured assets and derivatives to relatively unsophisticated “end users” such as pension funds, public agencies and insurance companies?
- Should the Congress place an effective, absolute limit on size and complexity of banks? What measures ought to be used to gauge market share?

Political Economy

- Does the inability of the Congress to govern its spending behavior and the related monetary policy accommodation by the Federal Reserve Board add to systemic risk for global financial institutions and markets?
- Does the fact of twin budget and current account deficits by the US add to the market/liquidity risk facing all global financial institutions? That is, is the heavily indebted US economy unstable and thus an engine for creating systemic events?

² My personal view is that systemic risk is a political concept akin to fear and not something measurable via scientific methods. See also “What is To Be Done With Credit Default Swaps?” *American Enterprise Institute*, February 23, 2009. See: http://www.rcwhalen.com/pdf/cds_aei.pdf

³ In classical terms, a legal contract recognized as such under common law requires the exchange of value between parties, but a credit default swap (“CDS”) fails this test. Instead, a CDS is better viewed as a “barrier option” in insurance industry terms or a gaming instrument like the New York Lottery. Because the buyer of protection does not need to deliver the underlying asset to collect the insurance payment, the parties may settle in cash and there is no limit on the number of open positions written against this basis – save the collateral requirements for such positions, if any. Because the effective collateral posted by dealers of CDS heretofore was low compared to effective end-user collateral requirements, the dealer leverage in the system was almost infinite and thus the systemic risk increased by an order of magnitude. In economic terms, CDS equates renters with owners, risk is increased and regulation is rendered at best irrelevant.

Prudential Regulation

Our nation's Founders tended to favor competition over monopoly, inefficiency and conflict, in the form of checks and balances, over efficiency and short-run practicality. The challenge for the national Congress remains, as it always has been, reconciling the need to be more efficient to achieve current public policy goals while remaining true to the legacy of deliberate inefficiency given to us by the framers of the Constitution.

Or to put it another way, the Founders addressed the systemic risk of popular rule by placing deliberately mechanical, inefficient checks and balances in our path. Similar checks are present in any well managed government or enterprise to prevent bad outcomes. In Sarbanes-Oxley risk terms, this is what we call "systems and controls."

For example, when the House of Representatives, reflecting current popular anger and indignation, passes tax legislation encouraging the cancelation of state law contracts and the effective confiscating of monies lawfully paid to executives at AIG, it falls to the Senate to withhold its support for the action by the lower chamber and instead counsel a more deliberate approach to advancing the public interest.

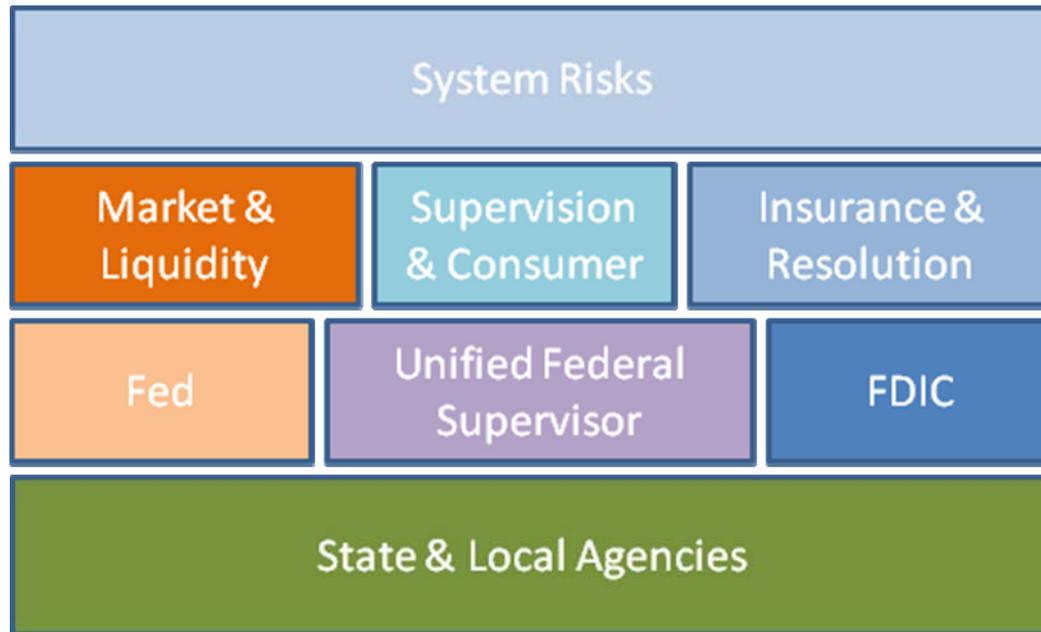
For example, were the Senate to put aside the House-passed measure and instead pass legislation that forces the Fed and Treasury push AIG into bankruptcy to forestall further public subsidies for this apparently insolvent company, the US Trustee for the Federal Bankruptcy Court arguably could seek to recover the bonuses paid to executives.

The Bankruptcy Trustee might also be able to recover the tens of billions of dollars in payments to counterparties such as Goldman Sachs (NYSE:GS), which has so far reportedly received \$20 billion in public funds paid and pledged. One might argue that the immediate bankruptcy of AIG is now in the best interest of the public because it provides the only effective way to a) claw-back bonuses and counterparty payments, and b) end further subsidies for this insolvent corporation.⁴

In my view, it serves the public interest to have multiple regulators sitting at the table in terms of managing what might be called "systemic risk," including both state and federal regulators. In the same way that the federal government has forced a cooperative relationship between local, state and federal law enforcement when it comes to anti-terrorism efforts, so too the Congress should end the competition between federal and state regulators illustrated by the legal battle over state-law preemption and instead mandate cooperation. In areas from prudential regulation to consumer protection, why cannot the federal government mandate broad standards to achieve policy objectives, then empower/compel state and federal agencies to cooperate in making these goals a reality?

⁴ For a discussion of the true purposes of the AIG rescue by the Fed, See Morgenson, Gretchen, "A.I.G.'s bailout priorities are in critics' cross hairs," *The New York Times*, March 17, 2009. Also, it must be noted that analysts in the risk management community such as Tim Freestone identified possible instability in the AIG business as early as 2001. AIG threatened to sue Freestone when he published his findings, which were documented at the time by the *Economist* magazine. Notables such as Henry Kissinger questioned the *Economist* story and said "I just want you to know that Hank Greenberg has more integrity than any person I have ever known in my life."

What makes no sense about the current system of regulation is having the various federal and state regulators compete amongst themselves over shared portions of the different components of risk as viewed from a public policy perspective, including market and liquidity risk, safety and soundness, and regulatory enforcement and consumer protection. Were I to have the opportunity to rearrange the map of the US regulatory system, here is how I would divide the areas of responsibility:



Seen from the perspective of the public, the risks facing the financial system can be divided into three large areas: a) market & liquidity risk management, b) regulatory enforcement and consumer protection, and c) deposit insurance and the resolution of insolvent institutions. Each area has implications for systemic stability. Let me briefly comment on each of these buckets and the agencies I believe should be tasked with responsibility for these areas in a restructured US regulatory system.

Market & Liquidity Risk

As the bank of issue and the provider of credit to the financial system, the Fed must clearly be given the lead with respect to providing market and liquidity risk management, and general market oversight and surveillance. The Fed's chief area of competency is in the area of monetary policy and financial market supervision. But I strongly urge the Congress to strip the Fed of its current, direct responsibility for financial institution supervision and consumer protection to help the agency better focus on its monetary and economic policy responsibilities, as well as an enhanced market surveillance effort.

The United States needs a single safety-and-soundness regulator for all financial institutions, even if they retain diversity in terms of charters and activities. Consider that no other major industrial nation in the world gives its central bank paramount responsibility for bank safety and soundness, and for good reason. Over the past decade,

the Fed has demonstrated an inability to manage the internal conflict between its role as monetary authority and its partial responsibility for supervising bank holding companies and their subsidiary banks.

While some people claim that the Glass-Steagall Act law dividing banking and commerce has been repealed, I remind you that the Bank Holding Company Act of 1956 is still extant. I urge the Congress to delete this statute in its entirety as part of any new financial services legislation. Indeed, given the size of the capital deficit facing the larger players in the banking industry, AIG, and the GSEs, it seems inevitable that the Congress will be compelled to allow industrial companies to enter the US banking sector.⁵

The Fed's internal culture, in my view, is dominated by academic economists whose primary focus is monetary policy and who view bank supervision as a troublesome, secondary task. The Fed economists to whom I particularly refer believe that markets are efficient, that investors are rational, and that encouraging products such as subprime securitizations and OTC derivative contracts are consistent with bank safety and soundness. The same Fed economists believe that big is better in the banking industry, even though the overwhelming data and statistical evidence suggests otherwise.⁶

Critics of the Fed are right to say that under Alan Greenspan, the central helped cause the subprime mortgage debacle, but not for the reasons most people think. Yes, the expansive monetary policy followed by the Fed earlier this decade was a big factor, but equally important was the active encouragement by Fed staff and other global regulators of over-the-counter derivatives and the use by banks of off-balance-sheet vehicles such as collateralized debt obligations (“CDOs”) for liability management.⁷

The combination of OTC derivatives, risk-based capital requirements championed by the Fed and authorized by Congress, and favorable accounting rules for off-balance sheet vehicles blessed by the SEC and the FASB, enabled Wall Street to create a de facto assembly line for purchasing, packaging, and selling unregistered, high-risk securities,

⁵ The subsidies for the GSEs, AIG, and Citigroup amounts to a transfer of wealth from American taxpayers to the institutional investors who hold the bonds and derivative obligations tied to these zombie institutions. All of these companies will require continuing cash subsidies if they are not resolved in bankruptcy. My firm estimates that the maximum probable loss for the top US banks with assets above \$10 billion, also known as Economic Capital, will be \$1.7 trillion through the cycle, of which \$1.4 trillion is attributable to the top four money center banks. With the operating loss subsidy required for the GSEs and AIG, the US Treasury could face a collective, worst-case funding requirement of \$4 trillion through the cycle.

⁶ Given the magnitude of the losses incurred over the past several years due to financial innovation, it is worth asking if economists or at least those economists involved in the securities industry and financial economics more generally should be licensed and regulated in some way. Several observers have suggested that rating agencies ought to be compelled to publish models used for rating OTC structured asset, thus it seems reasonable to ask economists and analysts to stand behind their work when it is used to create securities. For an excellent discussion of the misuse of mathematics and other quantitative tools expropriated from the physical sciences by economists, regulators, and investment professionals, see [“New Hope for Financial Economics: Interview with Bill Janeway,”](#) *The Institutional Risk Analyst*, November 17, 2008.

⁷ I recommend that the Committee study Martin Mayer’s 2001 book, [“The Fed: The Inside Story of How the World’s Most Powerful Financial Institution Drives the Markets,”](#) particularly Chapter 13, “Supervisions,” on the Fed’s role in bank regulation.

such as subprime collateralized CDOs, to a wide variety of institutional investors around the world. These illiquid, opaque securities now threaten the solvency of banks in the United States, Europe, and Asia.

Observers describe the literally thousands of structured investment vehicles created during the past decade as the "shadow banking system." But few appreciate that this deliberately opaque, unregulated market came into existence and grew with the direct approval and encouragement of the Fed's leadership and the academic research community from which many Fed officials are drawn to this day. For every economist nominated to the Fed Board, the Senate should insist on a non-economist candidate!

Simply stated, in my view monetary economists are not competent to supervise financial institutions nor to set policy for regulating these institutions, yet successive Presidents and Congresses have populated the Fed's board with precisely such skilled professionals. While the more conservative bank supervision personnel at the 12 regional Federal Reserve banks and within agencies such as the OCC, OTS and FDIC often opposed ill-considered liberalization efforts such as OTC derivatives and the abortive Basel II accord, the Fed's powerful, isolated Washington staff of academic economists almost always had its way – and the Congress supported and encouraged the Fed even as that agency's policies undermined the safety and soundness of our financial markets.

The result of our overly generous tolerance for economist dabbling in the real world of banking and finance is a marketplace where some of the largest U.S. banks are in danger of insolvency, because their balance sheets are laden with illiquid, opaque and thus toxic OTC instruments that nobody can value or trade – instruments which the academic economists who populate the Fed actively encouraged for many years. Remember that comments by Fed officials made over the years to the Congress lauding these very same OTC cash and derivative instruments are a matter of public record. Given the Fed's manifest failure to put bank safety and soundness first, I believe that the Congress needs to rethink the role of the Fed and reject any proposal to give the Fed more authority to supervise investment banks and hedge funds, for example, not to mention the latest economist policy infatuation, "systemic risk."

We can place considerable blame on the Fed for the subprime crisis, but it must be said that an equally important factor was the tendency of Congress to use financial regulatory and housing policy to raise money and win elections. Members of Congress in both parties have freely used the threat of new regulation to extort contributions from the banking and other financial industries, often with little pretense as to their true agenda. Likewise, the Congress has been generous in providing with new loopholes and opportunities for regulatory arbitrage, enabling the very unsafe and unsound practices in terms of mortgage lending, securitization and the derivatives markets that has pushed the global economy into a deflationary spiral.

Let us never forget that the subprime housing bubble that began the present crisis came about with the active support of the Congress, two different political administrations, the GSEs, the mortgage, real estate, banking, securities and homebuilding industries, and

many other state and local organizations. It should also be recalled that the 1991 amendment to the Federal Reserve Act which allowed the Fed of New York to make the ill-advised bailout loans to AIG and other companies was added to the FDICIA legislation in the eleventh hour, with no debate, by members of this Committee and at the behest of officials of the Federal Reserve. The FDICIA legislation, let's recall, was intended to protect the taxpayer from loss due to bailouts for large financial institutions.⁸

Supervision & Consumer Protection

A unified federal supervisor should combine the regulatory resources of the Federal Reserve Banks, SEC, the OCC, and the Office of Thrift Supervision, to create a new safety-and-soundness agency explicitly insulated from meddling by the Executive Branch and the Congress. This agency should be responsible for setting broad federal standards for compliance with law and regulation, capital adequacy and consumer protection, and be accountable to both the Congress and the various states whose people it serves. As I mentioned before, the agency should be tasked to form cooperative alliances with state agencies to secure the objectives in each area of regulation. America has neither the time nor the money for regulatory turf battles.

As the Congress assembles the unified federal supervisor, it should include enhanced disclosure by all types of financial services entities, including hedge funds, non-bank mortgage origination firms and insurers, to name a few, so that regulators understand the contribution of these entities to the overall risk to the system, even if there is no actual prudential oversight of these entities at the federal level.

Insurance and Resolution

The Congress does not need to disturb existing state law regulation on insurance or mortgage origination in order to ensure that the unified federal regulator and FDIC have the power to reorganize or even liquidate the parents of insolvent banks. What is needed is a systemic rule so that all participants know what happens to firms that are mismanaged, take imprudent risks and become insolvent. So long as the Congress fashions a clear, unambiguous systemic rule regarding how and when the FDIC can act as the government's fully empowered receiver to resolve financial market insolvency, the markets will be reassured and the systemic stresses to the system reduced in the process.⁹

⁸ When the amendment to Section 13 of the FRA was adopted by the Senate, Fed Vice Chairman Don Kohn, then a senior Federal Reserve Board staffer, reportedly was present and approved the amendment for the Fed, with the knowledge and support of Gerry Corrigan, who was then President of the Federal Reserve Bank of New York and Vice Chairman of the FOMC. See also "[IndyMac, FDICIA and the Mirrors of Wall Street.](#)" *The Institutional Risk Analyst*, January 6, 2009.

⁹ While the commercial banking industry is required to provide extensive disclosure to the public, insurance companies have long dragged their feet when it comes to providing data to the public at a reasonable cost. Whereas members of the public can access machine-readable financial information about banks from portals such as the FDIC and FFIEC, in real time, comparable data on the US insurance industry is available only from private vendors and at great cost, meaning that the public has no effective, direct way to track the soundness of insurers.

The primary responsibility for insuring deposits and other liabilities of banks, and resolving troubled banks and their affiliates, should be given to the FDIC. Whereas the unified federal regulator will be responsible for oversight and supervision of all institutions, the FDIC should be given authority to a) publicly rate all financial institutions via the pricing of liability risk insurance, b) make the determination of insolvency of an insured depository institution, in consultation with the unified regulator and the Fed, and c) to reorganize any organization or company that is affiliated with an insolvent insured depository.

The cost of membership to the financial services club must be to either maintain the safety and soundness of regulated bank depositories or submit unconditionally to prompt corrective action by the FDIC to quickly resolve the insolvency. The Founders placed a federal mechanism for bankruptcy in the US Constitution for many reasons, but chief among them was the overriding need for finality to help society avoid prolonged damage due to insolvencies.

By focusing the FDIC on its role as the insurer of deposits and receiver for failed banks, and expanding its legal authority to restructure affiliates of failed banks, the Congress could solve many of the political and jurisdictional issues that now plague the approach to the financial crisis.

By giving the FDIC the primary authority to determine insolvency and the legal tools to restructure an entire organization in or out of formal receivership, situations such as the problems at Citigroup or AIG could more easily be resolved or even avoided. And by ending the doubt and ambiguity as to how insolvency is resolved, an enhanced role for the FDIC would reduce perceived systemic risk.

For example, if the FDIC had the legal authority to direct the restructuring of all of the units of Citigroup, the agency could collapse the entire Citigroup organization into a single national bank unit, mark the assets to market, wipe out the common and preferred equity, convert all of the parent company debt into new common equity, and contribute new government equity funds as well. The resulting bank would have 40-50% TCE vs. assets and would no longer be a source of systemic risk to the markets. Problem solved.

While the FDIC probably has the moral and legal authority to compel Citigroup to restructure along these lines (or face a traditional bank resolution), Congress needs to give the FDIC the power as receiver to make these type of changes unilaterally. In the case of a bankruptcy by AIG, FDIC could play a similar role, managing the insolvency process and assisting as the state insurance regulators take control of the company's insurance units. The remaining company would then be placed into bankruptcy.

In addition to giving the FDIC paramount authority as the guardian of safety and soundness and thus a key partner in managing the factors that comprise systemic risk, the Congress should give the FDIC the power to impose a fee on all bank liabilities, including foreign deposits and debt issued by companies that own insured depository institutions. All of the liabilities of a regulated depository must support the Deposit

Insurance Fund and the Congress should also modify its market share limitations to include liabilities, not merely deposits, for limiting size and thus the ability of a single institutions to destabilize the global financial system.

Systemic Risk Regulation

As I stated above, systemic risk is a symptom of other factors, a sort of odd political term spawned under the equally dubious rubric of identifying certain banks as being “Too Big To Fail.” When issues such as market structure and prudential regulation of institutions are dealt with adequately, the perceived “problem” of systemic risk will disappear.¹⁰

Consumer Protection and Credit Access

I believe that the Congress should give the unified federal regulator primary responsibility for enforcement of consumer protection and credit access laws. That said, however, I believe that the Congress should revisit the issue of federal preemption of state consumer fraud and credit laws. While there is no doubt that the federal government should set consistent regulations for all banks, there is no reason why federal and state agencies cannot cooperate to achieve these ends. The notion that consumer regulation must be an either or proposition is wrong.

As this Congress looks to reform the larger regulatory framework, a way must be found to allow for cooperation between state and federal agencies tasked with financial regulation and in all areas, including consumer and enforcement. There is no federal tort law, after all, so if consumers are to have effective redress of grievance for bad acts such as fraud or predatory lending, then the agencies and courts of the various states must be part of the solution.

Risk Management

In terms of risk management priorities, I believe that the Congress must take steps to resolve the market structure and bank activities problems suggested in the questions at the start of my remarks. Specifically, I believe that the Congress should:

- Require that all OTC derivatives be traded on organized exchanges, that the terms of most contracts be standardized, and that the exchange act as counterparty to all trades and enforce all margin requirements equally on dealers and end users alike. The notion that merely creating automated clearing solutions for CDS contracts, for example, will address the systemic risk issues is mistaken, in my view.¹¹
- Require that all structured assets such as mortgage securitizations be registered with the SEC. It is worth noting that an [affiliate of the NASDAQ](#) currently quotes public prices on all of the covered mortgage bonds traded in Denmark. Such a

¹⁰ For a discussion of the origins of “Too Big To Fail,” see [“Gone Fishing: E. Gerald Corrigan and the Era of Managed Markets,”](#) *The Herbert Gold Society*, February 1993.

¹¹ See Pirrong, Craig, [“The Clearinghouse Cure,”](#) *Regulation*, Winter 2008-2009.

system could be easily adapted for the US markets and almost overnight create a new legal template for private mortgage securitization.

- In terms of “originate to distribute” lending, the covered bond model may be the only means to “distribute” mortgage paper for some time to come. The idea currently popular inside the Fed and Treasury that now moribund securitization markets will revive is not even worthy of comment. The key issue for the future of securitizations is whether regulators can craft an explicit recognition of the legacy risk involved in “good sales.” It may be that, when actually described accurately, the risks involved in securitization outweigh the economic rewards.
- In terms of mark-to-market accounting, the fact that markets have focused on bank TCE, which like EBITDA is not a defined accounting term, illustrates the folly of trying to define and thereby constrain the preferences of investors and analysts via accounting rules.
 - Using TCE and CDS as valuation indicators, the market concludes that all large banks are insolvent. This is not just a matter of being “pro-cyclical” as is fashionable to say in economist circles, but rather of multiplying the already distorted, “market efficiency” perspective on value provided by mark-to-market into a short sellers bonanza. The Chicago School is wrong; short-term price is not equal to value.
 - If you make every financial firm on the planet operate under the same rules as a broker-dealer for market risk positions, then capital levels must rise and leverage ratios for all types of financial disintermediation must fall. Everything will be held to maturity, securitization will become exclusively a government activity and the US economy will stagnate. Mark-to-market implies a net reduction in credit to US consumer and the global economy that is causing and will continue to cause asset price deflation and a related political firestorm.
 - While the changes now proposed by the FASB to mark-to-market accounting may give financial institutions some relief in terms of rules-driven losses, falling cash flows behind many assets classes are likely to force additional losses by banks, insurers and other investors.

Finally, regarding credit ratings, I urge the Congress to remove from federal law any language suggesting or compelling a bank, agency or other investor to utilize ratings from a particular agency. There is no public policy good to be gained from creating a government monopoly for rating agencies. The best way to keep the rating agencies honest is to let them compete and be sued when their opinions are tainted by conflicts.¹²

¹² See “[Reassessing Ratings: What Went Wrong, and How Can We Fix the Problem?](#),” *GARP Risk Review*, October/November 2008.