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"Implications of the 'Volcker Rules' for Financial Stability"
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Good morning Chairman Dodd, Ranking Member Shelby, Members of the Committee. My name is Barry Zubrow, and I am the Chief Risk Officer and Executive Vice President of JPMorgan Chase & Co. Thank you for the opportunity to appear before the Committee today to discuss the Administration's recent proposals to limit the size and scope of activities of financial firms.

While the history of the financial crisis has yet to be written conclusively, we know enough about the causes – poor underwriting, too much leverage, weak risk management, excessive reliance on short-term funding, and regulatory gaps – to recognize that we need substantial reform and modernization of the regulatory structure for financial firms. Our current framework was patched together over many decades; when it was tested, we saw its flaws all too clearly.

We at JPMorgan Chase strongly support your efforts to craft and pass meaningful regulatory reform legislation that will provide clear, consistent rules for our industry. It is our view that the markets and the economy reflect continued uncertainty about the regulatory environment. I believe that economic recovery would be fostered by passage of a bill that charts a course for strong, responsible economic leadership from U.S. financial institutions. However, the details matter a great deal, and a bill that creates uncertainty or undermines the competitiveness of the US financial sector will not serve our shared goal of a strong, stable economy.

At a minimum, reform should establish a systemic regulator responsible for monitoring risk across our financial system. Let me be clear that responsibility for a company's actions rests solely with the company's management. However, had a systemic regulator been in place and closely watching the mortgage industry, it might have identified the unregulated pieces of the mortgage industry as a critical point of failure. It might also have been in a position to recognize the one-sided credit derivative exposures of AIG and the monoline insurers. While it may be unrealistic to believe that a systemic regulator could prevent future problems entirely, such a regulator may be able to mitigate the consequences of some failures and prevent them from collectively becoming catastrophic.

As we at JPMorgan Chase have stated repeatedly, no firm – including our own – should be too big to fail. The goal is to regulate financial firms so they don't fail; but when they run into trouble, all firms should be allowed to fail, regardless of their size or interconnections to other firms.

To ensure that this can happen – especially in times of crisis – regulators need enhanced resolution authority to wind down failing firms in a controlled way that does not put taxpayers or the broader economy at risk. Such authority can be an effective mechanism that makes it absolutely clear that there is no financial safety net for managements or shareholders.

Under such a system, a failed bank's shareholders should lose their investments; unsecured creditors should be at risk and, if necessary, wiped out. A regulator should be able to terminate management and boards and liquidate assets. Those who benefited from mismanaging risks or taking on inappropriate risk should feel the pain. Other aspects of the regulatory system also need to be strengthened – including consumer protection, capital standards and the oversight of the OTC derivatives market – but I emphasize systemic risk regulation and resolution authority specifically because they provide a useful framework for consideration of the most recent proposals from the Administration.

Restrictions on Proprietary Trading and Bank Ownership of Private Equity and Hedge Funds

Two weeks ago, the Administration proposed new restrictions on financial firms. The first would prohibit banks from "owning, investing in or sponsoring a hedge fund or a private equity fund, or proprietary trading operations" that are not related to serving customers. The new proposals are a divergence from the hard work being done by legislators, central banks and regulators around the world to address the root causes of the financial crisis and establish robust mechanisms to properly regulate systemically important financial institutions.

While there may be valid reasons to examine these activities, there should be no misunderstanding: the activities the Administration proposes to restrict did not cause the financial crisis. In no case were bank-held deposits threatened by any of these activities. Indeed, in many cases, those activities diversified financial institutions' revenue streams and served as a source of stability. The firms that failed did so largely as a result of traditional lending and real estate-related activities. The failures of Wachovia, Washington Mutual, Countrywide, and IndyMac were due to defaulting subprime mortgages. Bear Stearns, Lehman, and Merrill Lynch were all damaged by their excessive exposure to real estate credit risk.

Further, regulators currently have the authority to ensure that risks are adequately managed in the areas the Administration proposes to restrict. Regulators and capital standards-setting bodies are empowered, and must utilize those powers, to ensure that financial companies of all types are appropriately capitalized at the holding company level (as we are at JPMorgan Chase).

While bank holding companies may engage in proprietary trading and own hedge funds or private equity firms, comprehensive rules are in place that severely restrict the extent to which insured deposits may finance these activities. And regulators have the authority to examine all of these activities. Indeed, existing U.S. rules require that firms increase the amount of capital they hold as their private equity investments increase as a percentage of capital, effectively restraining their private equity portfolios.

While regulators have the tools they need to address these activities in bank holding companies, we need to take the next logical step of extending these authorities to all systemically important firms regardless of their legal structure. If the last two years have taught us anything, it is that threats to our financial system can and do originate in non-depository institutions. Thus, any new regulatory framework should reach all systemically important entities – including investment banks – whether or not they have insured deposit-based business; all systemically important institutions should be regulated to the same rigorous standard. If we leave outside the scope of rigorous regulation those institutions that are interconnected and integral to the provision of credit, capital and liquidity in our system, we will be right back where we were before this crisis began. We will return to the same regime in which Bear Stearns and Lehman Brothers both failed and other systemically-important institutions nearly brought the system to its knees. We cannot have two tiers of regulation for systemically-important firms.

As I noted at the outset, it is also very important that we get the details right. Thus far, the Administration has offered few details on what is meant by "proprietary trading." Some traditional bank holding company activities, including real estate and corporate lending, expose these companies to risks that have to be managed by trading desks. Any individual trade, taken in isolation, might appear to be "proprietary trading," but in fact is part of the mosaic of serving clients and properly managing the firm's risks. Restricting activities that could loosely be defined as proprietary trading would reduce the safety and soundness of our banking institutions, raise the cost of capital formation, and restrict the availability of credit for businesses, large and small – with no commensurate benefit in reduced systemic risk.

Similarly, the Administration has yet to define "ownership or sponsorship" of hedge fund and private equity activities. Asset managers, including JPMorgan Chase, serve a broad range of clients, including individuals, universities, and pensions, and need to offer these investors a broad range of investment opportunities in all types of asset classes. In each case, investments are designed to meet the specific needs of the client.

Our capital markets rely upon diversified financial firms equipped to meet a wide range of financing needs for companies of all sizes and at all stages of maturity, and the manner in which these firms are provided financing is continually evolving in response to market demand. Codifying strict statutory rules about which firms can participate will distort the market for these services – and result in more and more activities taking place outside the scope of regulatory scrutiny. Rather, Congress should mandate strong capital and liquidity standards, give regulators the authority they need to supervise these firms and activities, and conduct rigorous oversight to ensure accountability.

While we agree that the United States must show leadership in regulating financial firms, if we take an approach that is out of sync with other major countries around the world without demonstrable risk-reduction benefits, we will dramatically weaken our financial institutions' ability to be competitive and serve the needs of our clients. Asset management firms (including hedge funds and private investment firms) play a very important role in today's capital markets, helping to allocate capital between providers and users. The concept of arbitrarily separating different elements of the capital formation process appears to be under consideration only in the U.S. Forcing our most competitive financial firms to divest themselves of these business lines will make them less competitive globally, allowing foreign firms to step in to attract the capital and talent now involved in these activities. Foreign banks will gain when U.S. banks cede the field.

Concentration Limits

The second of the recent Administration proposals would limit the size of financial firms by "growth in market share of liabilities." Again, while the Administration has not provided much detail, the proposal appears to be based on the assumption that the size of financial firms or concentration within the financial sector contributed to the crisis.

If you consider the institutions that failed during the crisis, some of the largest and most consequential failures were stand-alone investment banks, mortgage companies, thrifts, and insurance companies – not the diversified financial firms that presumably are the target of this proposal. It was not AIG's and Bear Stearns' size but their interconnection to other firms that prompted the government to step in. In fact, JPMC's capabilities, size, and diversity were essential to our withstanding the crisis and emerging as a stronger firm – and put us in a position to acquire Bear Stearns and Washington Mutual when the government asked us to. Had we not been able to purchase these companies, the crisis would have been far worse.

With regard to concentration specifically, it is important to note that the U.S. financial system is much less concentrated than the systems of most other developed nations. Our system is the 2nd least concentrated among OECD countries, just behind Luxembourg; the top 3 banks in the U.S. held 34% of banking assets in 2007 vs. an average for the rest of the OECD of 69%.

An artificial cap on liabilities will likely have significant negative consequences. For the most part, banks' liabilities and capital support the asset growth of its loan and lending activities. By artificially capping liabilities, banks may be incented to reduce the growth of assets or the size of their existing balance sheet, which in turn would restrict their ability to make loans to consumers and businesses, as well as to invest in government debt. Capping the scale and scope of healthy financial firms cedes competitive ground to foreign firms and to less regulated, non-bank financial firms – which will make it more difficult for regulators to monitor systemic risk. It would likely come at the expense of economic growth at home. No other country in the world has a Glass-Steagall regime or the constraints recently proposed by the Administration, nor does any country appear interested in adopting one. International bodies have long declined to embrace such constraints as an approach to regulatory reform.

Conclusion

We have consistently endorsed the need for meaningful regulatory reform and have worked hard to provide the Committee and others with information and data to advance such reform. We agree that it is critically important to eliminate any implicit financial "safety net" by assuring appropriate capital standards, risk management and regulatory oversight on a consistent and cohesive basis for all financial firms, and, ultimately, having a robust regime that allows any firm to fail if it is mismanaged.

While numerical limits and strict rules may sound simple, there is great potential that they would undermine the goals of economic stability, growth, and job creation that policymakers are trying to promote. The better solution is modernization of our financial regulatory regime that gives regulators the authority and resources they need to do the rigorous oversight involved in examining a firm's balance sheet and lending practices. Effective examination allows regulators to understand the risks institutions are taking and how those risks are likely to change under different economic scenarios.

It is vital that policymakers and those with a stake in our financial system work together to overhaul our regulatory structure thoughtfully and well. Clearly such work needs to be done in harmony with other countries around the world. While the specific changes required by reform may seem arcane and technical, they are critical to the future of our whole economy. We look forward to working with the Committee to enact the reforms that will position our financial industry and economy as a whole for sustained growth for decades to come.

Thank you.