WRITTEN STATEMENT OF

EUGENE A. LUDWIG
CHIEF EXECUTIVE OFFICER, PROMONTORY
FINANCIAL GROUP

BEFORE THE

SENATE BANKING COMMITTEE FINANCIAL
INSTITUTIONS AND CONSUMER PROTECTION
SUBCOMMITTEE

AUGUST 3, 2011

WRITTEN STATEMENT OF

EUGENE A. LUDWIG
CHIEF EXECUTIVE OFFICER, PROMONTORY FINANCIAL GROUP

BEFORE THE

SENATE BANKING COMMITTEE FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION SUBCOMMITTEE

AUGUST 3, 2011

I would like to commend Chairman Brown, the Ranking Committee Member, Senator Corker, and the other members of this Committee for holding this hearing on Debt Financing in the Domestic Financial Sector. Chairman Brown and Ranking Member Corker, you and the rest of the Committee members can take pride in having worked hard to address the challenges posed by the financial crisis. You have brought important Congressional focus to the issues of financial stability, safety and soundness, and regulatory framework of financial institutions. You have passed landmark legislation in this area and continue to engage in serious oversight.

One of the greatest challenges facing not just the financial and regulatory communities but our economy as a whole is the successful implementation of the very powerful post-crisis reforms enacted by the Congress and the international reforms currently being proposed by the Basel Committee on Banking Supervision and the Financial Stability Board. Properly implemented in a balanced and thoughtful way these reforms should enhance financial stability in the United States.

If this balance is lost however, the potential exists – particularly given the potentially great cumulative impact of these rules – that the financial system will be actually less stable and less able to fulfill its key function in supporting the economy of the United States, putting a deleterious drag on capital formation and meaningful job opportunities for our people.

We must never lose sight of the fact that the financial crisis has taken a tremendous toll on our country. Millions of Americans are reeling from the loss of their jobs, their homes, and their life savings. We need the banking system to serve them again and to fulfill its critical role of supporting economic growth. Therefore, we must ensure that the hundreds of rules required by the Dodd-Frank Act are implemented with great care and in a coordinated fashion. The sum total of these reforms must contribute to the country's economic recovery and future stability.

In implementing the Dodd-Frank Act, it is important to emphasize that the Act is sufficiently comprehensive that each rulemaking should be evaluated with the recognition that the cumulative impact of the entirety of the Dodd-Frank Act reforms will have an immense, and not entirely predictable, impact. It is critical to take a thoughtful approach to the implementation of all of these reforms – domestic and international – with an eye towards maintaining the balance of the financial system and allowing the economy to recover and provide Americans with much-needed jobs and opportunity.

The modern financial system is a complex mechanism that can be a potent force for development and opportunity. It is hard to imagine how a developed economy can thrive without a robust financial system. But, as we have seen, modern finance – like every other human endeavor – has flaws. Both the Dodd-Frank Act and the rules proposed by the Basel Committee and the Financial Stability Board seek to rectify those flaws and provide the medicine needed for a stronger and safer financial system that can support the critical growth ultimately needed for America's recovery. This is truly an omnibus effort; the kind of change that occurs rarely more than once in a generation. However, like any strong medicine, if applied incorrectly or excessively, the Dodd-Frank Act, and the Basel Committee and Financial Stability Board reforms can produce more harm than good.

I have been a regulator, banker, and bank adviser for over 30 years. In these roles, I have developed, implemented, and evaluated complex financial system rules and controls. There are tremendous practical challenges in creating and maintaining control systems that function at a level that modern finance demands and that Congress, the regulatory community, and the public have a right to expect. Targeting resources to create controls that matter and refraining from imposing excess or overkill in reforms are key to successful implementation. Therefore, in this regard, I like to say that more is not better, better is better.

Capital Increases

The capital rules are a good case in point. Through the work of the Basel Committee, the Financial Stability Board, Congress, and U.S. regulators, we now have very tough capital requirements and capital levels that significantly exceed previous requirements.

The major source of higher minimum capital requirements is the work of the Basel Committee, in which the U.S. banking regulators play a lead role. Under current Basel capital rules, banks have to hold eight percent total capital and four percent Tier 1 capital – only half of which must be common equity. Under Basel III, which was issued in December 2010 and will be implemented beginning in 2013, banks will have to hold 10.5 percent total capital and seven percent common equity. On top of that, U.S. regulators may add on an additional "countercyclical capital buffer" of up to two and a half percent, which, as currently contemplated, must be composed of common equity. Furthermore, most financial institutions, out of concern that there will be adverse consequences if they breach – even for a short period of time – any of their regulatory minimum ratios, typically carry their own buffers in excess of those required.

It is hard to quantify just how much additional capital is being added to the requirements, both because of these complex definitional elements and the fact that U.S. implementation of Basel III and capital standards required by Title 1 of the

Dodd-Frank Act has not yet taken place. However, it is notable that under Basel III, banks have to hold a minimum of seven percent common equity, as opposed to a minimum of two percent common equity under Basel II (because half of the four percent Tier 1 minimum could be held as noncumulative preferred stock and certain hybrid instruments). This is over a three-fold increase in required common equity, before even factoring in additional buffers and revised risk weights described below.

This is an important change, because common equity is the highest quality of capital in terms of loss-absorbing ability, albeit also the most expensive for banks to raise. Furthermore, prior to the crisis several of our largest non-bank institutions, notably investment banks, were subject to a much less rigorous capital regime. Now, given changes occasioned by the financial crisis, as well as the ability of the Financial Stability Oversight Council (FSOC) to designate non-bank financial institutions as "systemically important", a number of institutions will see even more marked increases in the capital they are required to hold.

It should also be noted that after the financial crisis the Basel Committee revised certain risk weights on assets that had been instrumental in the financial disruption. For example, re-securitizations and trading assets now will have substantially higher risk weights beginning in 2012. The Basel Committee estimates that banks will hold four times the amount of capital on trading activities than under the current framework.

Finally, under a recent Basel Committee proposal, large complex banking companies – so called global SIFIs – will have to hold yet another capital buffer of one to two and a half percent.

The Importance of Balance

At the end of the day, capital is an important tool in the supervisory toolbox, but it is only one tool; therefore, I would not, at this time, advise any further increases in capital requirements beyond the tough new Basel rules. The Dodd-Frank Act provides capital requirements as a regulatory mechanism with other powerful tools to enhance safety and soundness of the financial system. While focusing on capital is appropriate, to do so to the exclusion of other important mechanisms for ensuring bank safety and soundness is risky. We take the chance of capital's becoming the Maginot Line of financial institution safety and soundness. Capital is a necessary condition for good safety and soundness, but it is not sufficient in and of itself.

In this regard, it is worth noting that bank failures in the recent crisis were typically not the result of banks running out of capital, but rather the result of liquidity weaknesses. The Dodd-Frank Act requires heightened liquidity standards for bank holding companies of $50 billion or more in assets. The Basel Committee is in the final stages of issuing stringent new liquidity rules. Furthermore, the Dodd-Frank Act provides regulators with an armory filled with other supervisory tools. Some of these tools are new, like the work of the Office of Financial Research (OFR), and resolution plans. Other tools are not new, but they are greatly enhanced, like stress testing and an increased emphasis on governance and risk management.

Taken as a whole, these tools, along with the significant powers already held by bank regulators, should be, at this point, adequate to greatly enhance financial stability. Taken to the extreme, any one or a group of these tools can prove harmful.

In this regard, it is important to recognize that the CAMELS supervisory rating system is one of the valuable ways to rate a banking organization's safety and soundness. The "E" in CAMELS stands for earnings. The E is there because regulators know that it is not possible for a banking organization to be truly safe if it does not earn steady and safe returns on a risk adjusted basis. Solid earnings allow banking organizations to make loans to firms that want to expand, develop new products and equipment, and take sensible risks so they can grow, providing jobs and prosperity. But, make no mistake; lending money to even the most sound businesses borrowers is a risky business even with the best borrowers, best collateral, and best ideas.

Without solid earnings, a banking organization cannot as easily attract capital, nor can it accumulate as much capital through retained earnings. In this regard, it is also worth emphasizing that nothing flows to the bottom line faster than expense, which quickly accumulates with increased capital and controls. While it is essential to have strong capital and strong controls, policy makers and regulators must remember that banks simply have to be able to bear the expense of the capital and controls that are needed. Excess capital and controls risk needlessly weighing down a banking organization.

Some would say that we can solve all the weaknesses in the financial system by adding capital, capital, and more capital. My view is different. Yes, capital is needed, and much capital is being added. But we need to be careful about excess. What is critically important to safety and soundness is balance, balance, and balance.

So how do you achieve the right balance? How do we ensure that our regulators and regulations are both serious and meaningful, but not so elaborate that they weigh down banks to the point of dysfunction? Unfortunately, there is no quick fix, but I can provide some suggestions.

A well functioning set of regulations and a sound regulatory mechanism starts with what you are doing at this hearing today: constant and thoughtful Congressional oversight. The next step is ensuring that our regulators continue to be top professionals who are devoted to a safe and sound banking system, one that supports prudent innovation and economic growth. Third, both from the standpoint of Congressional oversight and as a former regulator, we must avoid waste and excess in implementing our rules and procedures. Fourth, I would insist that our regulators periodically review their rules to insure that they are both effective and cause the least burden possible.

For example, our current system of multiple regulators is an area where the burden can be lessened. I have long advocated for one prudential safety and soundness regulator, not several. However, since that is the system under which U.S. banking institutions currently operate, we must encourage our fine regulatory agencies to divide the work in order to minimize duplication or triplication.

Finally, I want to note two other points that bear on sound implementation of the Dodd-Frank Act and international rules. First, it is essential that in implementing international capital and liquidity rules for global banks, we insist on a level playing field. Setting a requirement for the amount of risk-based capital we want banks to have globally will not be effective without uniform implementation. How we define the numerator – the capital itself, and the denominator – risk weighted assets, is critical. Equally important, we have to ensure that standards are applied fairly around the globe if we are to have global standards that do not simply put U.S. financial firms at a disadvantage.

This is not an easy issue. Today's Basel capital rules allow banks around the world to calculate, within certain parameters and approaches, the risk weights that apply to their portfolio of assets. While supervisors have a key role in overseeing and approving the models that the banks use for this purpose, there is an emerging view that some banks' models may be less rigorous than others.

From my experience as a former supervisor and banker, I can assure you that the U.S. supervisors have taken this task quite seriously and, accordingly, U.S. banks' models are quite rigorous. In fact, one of the primary reasons that U.S. banks are still in the transition stages of implementing Basel II is because of the high standards to which U.S. supervisors hold them. If some non-U.S. banks are allowed to use inadequate modeling to determine their capital risk weights, then U.S. banks may be at a significant competitive disadvantage. Moreover, the international banking system is only as strong as its weakest link. The Basel Committee is beginning to tackle this issue, which is a critical task before the higher Basel III and G-SIB (Global Systemically Important Bank) capital requirements become effective. Congress and U.S. regulators should be watchful here too.

Non-banks

Another area where more work needs to be done is outside of the banking system. Less-regulated non-bank financial players own one-quarter of U.S. financial sector assets. When our capital markets recover and many of the Dodd-Frank Act restrictions become effective, non-bank players are likely to become an even greater force. These entities – the so-called shadow banking system – can put on 20:1; 30:1 or even 50:1 leverage – effectively capital requirements as low as two percent. As long as this severe imbalance continues, it is a serious threat to the financial system. The FSOC has the authority to level this playing field in a variety of ways, including designating activities and non-bank institutions that present systemic risks to the financial system.

Here again, balance is key. We do want innovative, particularly smaller players to have room to grow; we do want to encourage free markets. However, where anomalies become large either in terms of size or imbalance, the better players are pushed further out on the risk curve than is desirable and the weaker players become ever more likely to fail and cause disruption.

Macro-prudential Supervision

One area where implementation of the Dodd-Frank Act is particularly important is with respect to the OFR, which was created to monitor, on behalf of the FSOC, present and emerging systemic risks in the financial system. OFR is one of the most important positive and creative developments resulting from the Dodd-Frank Act. Functioning correctly, the OFR should give regulators, the financial system and Congress better headlights as to where the financial system is headed and any potholes along the road.

However, for the OFR to function effectively, it must have a Congressionally-confirmed director and sufficient staff so it can conduct systemic risk analysis and present independent views to both the FSOC and to Congress.

Further, and enormously important, the OFR should work hard not to create undue additional burdens for the financial system. It needs to faithfully execute its mandate to use existing data wherever possible, coordinate its data gathering activities, and standardize data collection so the same information is not reported multiple times in multiple formats.

Conclusion

Finally, I would like to say a word about the banking system and getting our economy moving again. While the fundamental problem with credit right now is a sluggish overall economy, at the margin, the elements exist today for a credit crunch much like the time I entered office in 1993. In 1993, supervisors and bankers were recovering from a period of boom and bust. The supervisory pendulum had swung to excess caution in some areas of the country.

Today, the combination of a plethora of new rules to implement in addition to supervisory caution – of course a natural reaction to a difficult period – threatens to dampen economic growth. It is essential for all parties to work towards balance. Regulation and supervision can be both effective and tough, but balanced, allowing for safe lending and capital formation. We must all continue to work to strike this balance.