

EMBARGOED UNTIL DELIVERY

STATEMENT OF

**SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION**

on

**STRENGTHENING AND STREAMLINING
PRUDENTIAL BANK SUPERVISION**

before the

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

**August 4, 2009
Room 534, Dirksen Senate Office Building**

Chairman Dodd, Ranking Member Shelby and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the importance of reforming our financial regulatory system. Specifically, you have asked us to address the regulatory consolidation aspects of the Administration's proposal and whether there should be further consolidation.

The proposals put forth by the Administration regarding the structure of the financial system and the supervision of financial entities provide a useful framework for discussion of areas in vital need of reform. The goal of any reforms should be to address the fundamental causes of the current crisis and to put in place a regulatory structure that guards against future crises.

There have been numerous proposals over the years to consolidate the federal banking regulators. This is understandable given the way in which the present system developed, responding to new challenges as they were encountered. While appealing in theory, these proposals have rarely gained traction because prudential supervision of FDIC insured banks has held up well in comparison to other financial sectors in the United States and against non-U.S. systems of prudential supervision. Indeed, this is evidenced by the fact that large swaths of the so-called shadow banking sector have collapsed back into the healthier insured sector, and U.S. banks -- notwithstanding their current problems -- entered this crisis with less leverage and stronger capital positions than their international competitors.

Today, we are again faced with proposals to restructure the bank regulatory system, including the suggestion of some to eliminate separate federal regulators for national- and state-chartered institutions. We have previously testified in support of a systemic risk council which would help assure coordination and harmonization in prudential standards among all types of financial institutions, including commercial banks, investment banks, hedge funds, finance companies, and other potentially systemic financial entities to address arbitrage among these various sectors. We also have expressed support for a new consumer agency to assure strong rules and enforcement of consumer protection across the board. However, we do not see merit or wisdom in consolidating federal supervision of national and state banking charters into a single regulator for the simple reason that the ability to choose between federal and state regulatory regimes played no significant role in the current crisis.

One of the important causes of the current financial difficulties was the exploitation of the regulatory gaps that existed between banks and the non-bank shadow financial system, and the virtual non-existence of regulation of over-the-counter (OTC) derivative contracts. These gaps permitted lightly regulated or, in some cases, unregulated financial firms to engage in highly risky practices and offer toxic derivatives and other products that eventually infected the financial system. In the absence of regulation, such firms were able to take on risks and become so highly levered that the slightest change in the economy's health had deleterious effects on them, the broader financial system, and the economy.

Gaps existed in the regulation and supervision of commercial banks -- especially in the area of consumer protection -- and regulatory arbitrage occurred there as well. Despite the gaps,

bank regulators maintained minimum standards for the regulation of capital and leverage that prevented many of the excesses that built-up in the shadow financial sector.

Even where clear regulatory and supervisory authority to address risks in the system existed, it was not exercised in a way that led to the proper management of those risks or to provide stability for the system, a problem that would potentially be greatly enhanced by a single federal regulator that embarked on the wrong policy course. Prudent risk management argues strongly against putting all your regulatory and supervisory eggs in one basket. Moreover, a unified supervisor would unnecessarily harm the dual banking system that has long served the financial needs of communities across the country and undercut the effectiveness of the deposit insurance system.

In light of these significant failings, it is difficult to see why so much effort should be expended to create a single regulator when political capital could be better spent on more important and fundamental issues which brought about the current crisis and the economic harm it has done. In addition, a wholesale reorganization of the bank regulatory and supervisory structure would inevitably result in a serious disruption to bank supervision at a time when the industry still faces major challenges. Based on recent experience in the federal government with such large scale agency reorganizations, the proposed regulatory and supervisory consolidation, directly impacting the thousands of line examiners and their leadership, would involve years of career uncertainty and depressed staff morale. At a time when the supervisory staffs of all the agencies are working intensively to address challenges in the banking sector, the resulting distractions and organizational confusion that would follow from consolidating the banking agency supervision staffs would not result in long term benefits. Any benefits would likely be offset by short term risks and the serious disadvantages that a wholesale reorganization poses for the dual banking system and the deposit insurance system.

My testimony will discuss the issues raised by the creation of a single regulator and supervisor and the impact on important elements of the financial system. I also will discuss the very important roles that the Financial Services Oversight Council and the Consumer Financial Protection Agency (CFPA) can play in addressing the issues that the single federal regulator and supervisor apparently seeks to resolve, including the dangers posed by regulatory arbitrage through the closing of regulatory gaps and the application of appropriate supervisory standards to currently unregulated non-bank financial companies.

Effects of the Single Regulator Model

The current financial supervisory system was created in a series of ad hoc legislative responses to economic conditions over many years. It reflects traditional themes in U.S. history, including the observation in the American experience that consolidated power, financial or regulatory, has rarely resulted in greater accountability or efficiency.

The prospect of a unified supervisory authority is alluring in its simplicity. However, there is no evidence that shows that this regulatory structure was better at avoiding the widespread economic damage that has occurred over the past two years. The financial systems

of Austria, Belgium, Hungary, Iceland and the United Kingdom have all suffered in the crisis despite their single regulator approach. Moreover, it is important to point out that the single regulator system has been adopted in countries that have highly concentrated banking systems with only a handful of very large banks. In contrast, our system, with over 8,000 banks, needs a regulatory and supervisory system adapted to a country of continental dimensions with 50 separate states, with significantly different economies, and with a multiplicity of large and small banks.

Foreign experience suggests that, if anything, the unified supervisory model performed worse, not better than a system of multiple regulators. It should be noted that immediately prior to this crisis, organizations representing large financial institutions were calling aggressively for a move toward the consolidated model used in the UK and elsewhere.¹ Such proposals were viewed by many at the time as representing an industry effort to replicate in this country single regulator systems viewed as more accommodative to large, complex financial organizations. It would indeed be ironic if Congress now succumbed to those calls. A regulatory structure based on this approach would create serious issues for the dual banking system, the survival of community banks as a competitive force, and the strength of the deposit insurance system that has served us so well during this crisis.

The Dual Banking System

Historically, the dual banking system and the regulatory competition and diversity that it generates has been credited with spurring creativity and innovation in financial products and the organization of financial activities. State-chartered institutions tend to be community-oriented banks that are close to their communities' small businesses and customers. They provide the funding that supports economic growth and job creation, especially in rural areas. They stay close to their customers, they pay special personal attention to their needs, and they are prepared to work with them to solve unanticipated problems. These community banks also are more accountable to market discipline in that they know their institution will be closed if they become insolvent rather than being considered too big to fail.

A unified supervisory approach would inevitably focus on the largest banks to the detriment of the community banking system. This could, in turn, feed further consolidation in the banking industry -- a trend counter to current efforts to reduce systemic exposure to very large financial institutions and end too big too fail.

Further, if the single regulator and supervisor is funded, as the national bank regulator and supervisor is now funded, through fees on the state-chartered banks it would examine, this would almost certainly result in the demise of the dual banking system. State-chartered institutions would quickly switch to national charters to escape paying examination fees at both the state and federal levels.

¹ See New York City Economic Development Corporation and McKinsey & Co., *Sustaining New York's and the U.S.' Global Financial Services Leadership*, January 2007. See also Financial Services Roundtable, *Effective Regulatory Reform*, Policy Statement, May 2008.

The undermining of the dual banking system through the creation of a single federal regulator would mean that the concerns and challenges of community banks would inevitably be given much less attention or even ignored. Even the smallest banks would need to come to Washington to try to be heard. In sum, a unified regulatory and supervisory approach could result in the loss of many benefits of the community banking system.

The Deposit Insurance System

The concentration of examination authority in a single regulator would also have an adverse impact on the deposit insurance system. The FDIC's ability to directly examine the vast majority of financial institutions enables it to identify and evaluate risks that should be reflected in the deposit insurance premiums assessed on individual institutions. The loss of an ongoing significant supervisory role and the associated staff would greatly diminish the effectiveness of the FDIC's ability to perform its congressionally mandated role -- reducing systemic risk through risk based deposit insurance assessments and containing the potential costs of deposit insurance by identifying, assessing and taking actions to mitigate risks to the Deposit Insurance Fund.

If the FDIC were to lose its supervisory role to a unified supervisor, it would need to rely heavily on the examinations of that supervisor. In this context, the FDIC would need to expand the use of its backup authority to ensure that it is receiving information necessary to properly price deposit insurance assessments for risk. This would result in duplicate exams and increased regulatory burden for many financial institutions.

The FDIC as a bank supervisor also brings the perspective of the deposit insurer to interagency discussions regarding important issues of safety and soundness. During the discussions of the Basel II Advanced Approaches, the FDIC voiced deep concern about the reductions in capital that would have resulted from its implementation. Under a system with a unified supervisor, the perspective of the deposit insurer might not have been heard. It is highly likely that the advanced approaches of Basel II would have been implemented much more quickly and with fewer safeguards, and banks would have entered the crisis with much lower levels of capital. In particular, the longstanding desire of many large institutions for the elimination of the leverage ratio would have been much more likely to have been realized in a regulatory structure in which a single regulator plays the predominant role. This is a prime example of how multiple regulators' different perspectives can result in a *better* outcome.

Regulatory Capture

The single regulator approach greatly enhances the risk of regulatory capture should this regulator become too closely tied to the goals and operations of the regulated banks. This danger becomes much more pronounced if the regulator is focused on the needs and problems of large banks -- as would be highly likely if the single regulator is reliant on size-based fees for its funding. The absence of the existence of other regulators would make it much more likely that such a development would go undetected and uncorrected since there would be no standard

against which the actions of the single regulator could be compared. The end result would be that the damage to the system would be all the more severe when the problems produced by regulatory capture became manifest.

One of the advantages of multiple regulators is that they provide standards of performance against which the conduct of their peers can be assessed, thus preventing any single regulator from undermining supervisory standards for the entire industry.

Closing the Supervisory Gaps

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

To prevent further arbitrage between the bank and non-bank financial systems, the FDIC supports the creation of a Financial Services Oversight Council and the CFPA. Respectively, these agencies will address regulatory gaps in prudential supervision and consumer protection, thereby eliminating the possibility of financial service providers exploiting lax regulatory environments for their activities.

The Council would oversee systemic risk issues, develop needed prudential policies and mitigate developing systemic risks. A primary responsibility of the Council should be to harmonize prudential regulatory standards for financial institutions, products and practices to assure that market participants cannot arbitrage regulatory standards in ways that pose systemic risk. The Council should evaluate differing capital standards which apply to commercial banks, investment banks, investment funds, and others to determine the extent to which differing standards circumvent regulatory efforts to contain excess leverage in the system. The Council also should undertake the harmonization of capital and margin requirements applicable to all OTC derivatives activities -- and facilitate interagency efforts to encourage greater standardization and transparency of derivatives activities and the migration of these activities onto exchanges or central counterparties.

The CFPB would eliminate regulatory gaps between insured depository institutions and non-bank providers of financial products and services by establishing strong, consistent consumer protection standards across the board. It also would address another gap by giving the CFPB authority to examine non-bank financial service providers that are not currently examined by the federal banking agencies. In addition, the Administration's proposal would eliminate the potential for regulatory arbitrage that exists because of federal preemption of certain State laws. By creating a floor for consumer protection and allowing more protective State consumer laws to apply to all providers of financial products and services operating within a State, the CFPB should significantly improve consumer protection.

A distinction should be drawn between the macro-prudential oversight and regulation of developing risks that may pose systemic risks to the U.S. financial system and the direct supervision of financial firms. The macro-prudential oversight of system-wide risks requires the integration of insights from a number of different regulatory perspectives -- banks, securities firms, holding companies, and perhaps others. Only through these differing perspectives can there be a holistic view of developing risks to our system.

Prudential supervisors would regulate and supervise the institutions under their jurisdiction, and enforce consumer standards set by the CFPB and any additional systemic standards established by the Council. Entities that are already subject to a prudential supervisor, such as insured depository institutions and financial holding companies, should retain those supervisory relationships. In addition, for systemic entities not already subject to a federal prudential supervisor, and to avoid the regulatory arbitrage that is a source of the current problem, the Council should be empowered to require that they submit to such oversight. Presumably this could take the form of a financial holding company under the Federal Reserve -- without subjecting them to the activities restrictions applicable to these companies.

There is not always a clear demarcation of these roles and they will need to coordinate to be effective. Industry wide standards for safety and soundness are based on the premise that if most or all banking organizations are safe, the system is safe. However, practices that may be profitable for a few institutions may not be prudent if that same business model is adopted by a large number of institutions. From our recent experience we know that there is a big difference between one regulated bank having a high concentration of sub-prime loans and concentrations of sub-prime lending across large sections of the regulated and non-regulated financial system. Coordination of the prudential and systemic approaches will be vital to improving supervision at both the bank and systemic level.

Risk management is another area where there should be two different points of view. Bank supervisors focus on whether a banking organization has a reasonable risk management plan for its organization. The systemic risk regulator would look at how risk management plans are developed across the industry. If everyone relies on similar risk mitigation strategies, then no one will be protected from the risk. In other words, if everyone rushes to the same exit at the same time, no one will get out safely.

Some may believe that financial institutions are able to arbitrage between regulators by switching charters. This issue has been addressed directly by recent action by the federal

banking regulators to coordinate prudential supervision so institutions cannot evade uniform enforcement of regulatory standards. The agencies all but eliminated any possibility of this in the recent issuance of a Statement on Regulatory Conversions that will not permit charter conversions that undermine the supervisory process. The FDIC would support legislation making the terms of this agreement binding by statute. We also would support time limits on the ability to convert. The FDIC has no statutory role in the charter conversion process. However, as insurer of all depository institutions, we have a vital interest in protecting the integrity of the supervisory process and guarding against any possibility that the choice of a federal or state charter could undermine that process.

Conclusion

The focus of efforts to reform the financial system should be the elimination of the regulatory gaps between banks and non-bank financial providers outside the traditional banking system, as well as between commercial banks and investment banks. Proposals to create a unified supervisor would undercut the benefits of diversity that are derived from the dual banking system and that are so important to a very large country with a very large number of banks chartered in multiple jurisdictions with varied local needs. As evidenced by the experience of other much smaller countries with much more concentrated banking systems, such a centralized, monolithic regulation and supervision system has significant disadvantages and has resulted in greater systemic risk. A single regulator is no panacea for effective supervision.

Congress should create a Financial Services Oversight Council and Consumer Financial Protection Agency with authority to look broadly at our financial system and to set minimum uniform rules for the financial sector. In addition, the Administration's proposal to create a new agency to supervise federally-chartered institutions will better reflect the current composition of the banking industry. Finally, but no less important, there needs to be a resolution mechanism that encourages market discipline for financial firms by imposing losses on shareholders and creditors and replacing senior management in the event of failure.

I would be pleased respond to your questions.