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EUGENE A. LUDWIG
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SENATE COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS

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Introduction

Chairman Dodd, Ranking Member Shelby, and other distinguished members of the Senate Banking Committee; I am honored to be here today to address the important subject of financial services regulatory reform. I want to commend you and the other members of the committee and staff for the serious, thoughtful, and productive way in which you have examined the causes of the financial crisis and the need for reform in this area.

Today, there are few subjects more important than reform of the financial services regulatory mechanism. Notwithstanding the fine men and women who work tirelessly at our financial regulatory agencies, the current outdated structure of the system has failed America. At this time last year, we were living through a near meltdown of the world's financial system, triggered by weaknesses generated here in the United States. Two of our largest investment banks and our largest insurance company failed. Our two giant GSE's failed. Three of our largest banking organizations were merged out of existence to prevent them from failing.

But the problem is not just about an isolated incident of one year's duration. Over the past 20-plus years we have witnessed the failure of hundreds of U.S. banks and bank holding companies. The failures have included national banks, state member banks, state non-member banks and savings banks, big banks and small banks, dozens if not hundreds of banks supervised by every one of our regulatory agencies. By the end of this year alone, I believe over 100 U.S. banks will have failed, costing the deposit insurance fund tens of billions of dollars. And, I judge that before this crisis is over we will witness the failures of hundreds more. In the face of this irrefutable evidence, it is impossible to say something is not seriously wrong.

Now is the time to act boldly and bring American leadership back to this system. A failure to act boldly and wisely will condemn America either to a loss of leadership in this critical area of our economy and/or additional instances of the kinds of financial system failures that we have been living through increasingly over the past several decades, the most pronounced instance of which is currently upon us.

No one should underestimate the complexity of accomplishing the needed reforms, though in truth the changes that are needed are surprisingly straightforward from a conceptual perspective. The Administration's financial services regulation White Paper is commendable and directionally correct. It identifies the major issues in this area and provides momentum for reform. In my view, certain essential refinements to the plan laid out in the White Paper are needed; the need for

revisions and refinements is an inevitable part of the policy-making process. I also want to commend the Treasury Department of former Secretary Henry Paulson for having developed its so-called "blueprint," which also has added important and positive elements to the debate in this area.

Financial services regulatory reform is not fundamentally a partisan issue. It is fundamentally a professional issue. And, under the leadership of you and your staffs Chairman Dodd and former Ranking Member Shelby the traditions of the Senate Banking Committee, which for decades has prided itself on a balanced bipartisan look at the facts and the needs of the country has continued. In this regard, it should be noted that many of the matters I cover below, including importantly the need for an end-to-end consolidated banking regulator, have been championed over the years by members of the Senate Banking Committee, including its Chairmen, from both sides of the aisle. Similarly, many of these concepts, including the need for an end-to-end consolidated institutional supervisor, have been championed by Treasury Secretaries over the years from both political parties.

I have set out below the seven critical steps that are needed to fix the American Financial Regulatory system and to refine the approaches put forth by both the current and previous Treasury Departments. Being so direct is no doubt somewhat presumptuous on my part, but I have been fortunate in my career to have worked in multiple capacities with the financial services industry and consumer organizations in this country and abroad, including as a regulator, money-center bank executive,

board member, major investor in community banks and chairman and board member of community development and consumer-related organizations.

So what has gone so wrong? Let me begin by saying what the problem is not.

- First, the problem is not the failure to have thousands of talented people working in bank and bank holding company supervision. I can testify from personal experience that we do indeed have exceptionally fine and able men and women in all our regulatory agencies.

- Second, our banks and bank holding companies are not subject to weak regulations. On the contrary, though not without flaws, our codes of banking regulations are no less stringent than those in countries that have weathered the current and past crises well.

- Third, it is not because America has weaker bankers than in the countries that have been more successful at dealing with the current crisis. On the contrary, we have a right to take pride in America's banks and bankers many of whom work harder than their peers abroad, have higher standards than their peers abroad and contribute more to their communities in civic projects than their peers abroad.

Of course, we have had isolated cases of regulators and bankers that failed in their duties. However, 20-plus years with hundreds of bank failures through multiple economic cycles is not the result of a few misguided souls.

So what is the problem with financial institution safety and soundness in the United States and how can we fix it? To my mind, the answer is relatively straightforward, and I have outlined it in the seven areas I cover below.

Needed Reforms

1. ***Streamline the current "alphabet soup" of regulators by creating a single world-class financial institution-specific, end-to-end, regulator at the federal level while retaining the dual banking system.***

a. *Introduction.* We must dramatically streamline the current alphabet soup of regulators. The regulatory sprawl that exists today is, as this committee well knows, a product of history, not deliberation. The recent financial crisis has accentuated many of the shortcomings of the current regulatory system.

Indeed, it is worth noting that our dysfunctional regulatory structure exists virtually nowhere else. And, I am not aware of any scholar or any country that believes it is the paradigm of financial regulatory structuring; nor am I aware of one country anywhere that wants to copy it.

b. *How Our Regulatory Structure Fails:* There are at least seven ways in which our current regulatory structure fails:

- *Needless Burdens That Weaken Safety and Soundness Focus.* First, a profusion of regulators, such as we have in the United States, adds too much needless burden to the financial services system. Additional burdens where they do not add value are not neutral. They actually diminish safety and soundness. Many banking organizations today have several regulatory agencies to contend with and dozens – in a few cases – hundreds of annual regulatory examinations with which to cope. At the same time, top management's time is not infinite. It is important to streamline and target regulatory oversight, and accordingly top management talent's focus to address those issues that most threaten safety and soundness.

- *Lack of Scale Needed to Address Problems in Technical Areas.* Second, under our current regulatory structure, not one of the institutional regulators is sufficiently large or comprehensive enough in their supervisory coverage to adequately ensure institutional safety and soundness. Typically, no regulator today engages in end-to-end supervision as different parts of the larger financial organizations are supervised by different regulatory entities. And gaining scale in

regulatory specialties of importance, for example, risk metrics, or capital markets activities, is severely hampered by the too small and fractured nature of supervision today in America.

- *Regulatory Arbitrage.* Third, the existence of multiple regulatory agencies is fertile ground for regulatory arbitrage, thereby seriously undercutting strong prudential regulation and supervision.

- *Delayed Rulemaking.* Fourth, rulemaking while often harmonized at least among the banking supervisors is slow to advance because of squabbles among the financial services regulators that can last for years at a time.

- *Regulatory Gaps.* Fifth, because our regulatory structure is a hodgepodge, for all its multiple regulators and inefficiencies, it is not truly "end-to-end" and has been prone to serious gaps between regulatory agency responsibilities where there is little or no supervision. And these gaps are often exploited by financial institutions, overburdened by too much regulation in other areas -- weeds take root and flourish in the cracks of the sidewalk.

- *Limitations on Investigations.* Sixth, where an experienced and talented bank regulator believes he or she has found a problem in the

bank, that individual or his or her regulatory agency cannot follow the danger beyond the legalistic confines of the chartered bank itself. "Hot pursuit" is not allowed in bank regulation today. We count on our bank examiners to function as a police force of sorts. But even when our bank detectives and cops sniff out trouble, they may have to quit following the trail when they hit "the county line" where another agency's jurisdiction begins. Like county sheriffs, examiners sometimes can do little more than plead with the examiners in the neighboring jurisdiction to follow up on the matter.

- *Diminished International Leadership.* Seventh, our hydra-headed regulatory system, with periodic squabbles among its various components, increasingly undercuts our moral force around the world, leading to a more fractured and less hospitable regulatory environment for U.S.-based financial services providers.

Let me elaborate on two of these points – the counterproductive nature of excess burdens and regulatory arbitrage:

Counterproductive Burdens. Today, a large financial institution that has a bank in its chain is in almost all cases subject to regulation by a bank regulator, the federal bank regulator, (the federal component of which will be the Office of the Comptroller of the Currency, the

Federal Reserve Board, the Federal Deposit Insurance Corporation, or the Office of Thrift Supervision) and in many cases by a state bank regulator. Many banking organizations have national banks, state banks and savings banks in their chains, so they are subject to all these bank supervisors.

In addition, every institution with a bank in its chain must have either the Federal Reserve or the OTS as its bank holding company and non-bank affiliate regulator.

In all cases, financial services companies with bank affiliates are subject to the FDIC as an additional supervisor.

But the list does not stop there. Additional supervision may be performed by the state Attorneys General, the Securities and Exchange Commission, and the Financial Industry Regulatory Authority. For Bank Secrecy Act, Foreign Corrupt Practices Act, and anti-money laundering matters there is a supervisory role for the Financial Crimes Enforcement Network and Office of Foreign Asset Control. Also, the insurance company subsidiaries of bank holding companies may be subject to regulation by state insurance regulators in each of the states. In addition, at times, even the Federal Trade Commission serves as a supervisor. And, the Justice Department

sometimes becomes involved in what historically might have been considered civil infractions of various rules. Even the accounting standard setting agencies directly or through the SEC, get into the act.

This alphabet soup of regulators results in multiple enforcement actions, often for the same wrong, and dozens of examinations, which as I have noted for our largest institutions may literally total in the hundreds in a year. There are so many needless burdens caused by this cacophony of regulators, rules, examinations and enforcement activities that many financial services companies shift their business outside the United States whenever possible.

But the burden is not in and of itself what is most concerning. The worst feature of our current system is that for all the different regulators, the back-up supervision and the volumes of regulation has not produced superior safety and soundness results. On the contrary, based on the track record of at least the last 20-plus years, it has produced less safety and soundness than some simplified foreign systems. As the current crisis and the past several debacles have shown, our current expensive and burdensome system does not work.

Regulatory Arbitrage. Financial institutions that believe their current regulator is too tough can change regulatory regimes by simply

flipping charters and thus avoid strong medicine prescribed by the previous prudential supervisor. Indeed, even where charter flipping does not actually occur, the threat of it has pernicious implications. Sometimes stated directly, sometimes indirectly, often by the least well-run banking organization, the threat of charter flipping eats away at the ability of examiners and ultimately the regulatory agency to be the clear-eyed referee that the system needs them to be.

And, regulatory arbitrage is greatly increased by the funding disequilibrium in our system whereby the Comptroller's office must charge its banks more since state-chartered banks are in effect subsidized by the FDIC or the Fed. The practical significance of this disequilibrium cannot be overstated.

c. *Misconceptions.* There have been a number of misconceptions about what a consolidated end-to-end institutional supervisor is and what it is not, as well as the history of this kind of prudential regulator.

- *Not a Super Regulator.* First, an end-to-end consolidated institutional supervisor is not a "super regulator" along the lines of Britain's FSA. A consolidated institutional prudential regulator does not regulate financial markets like the FSA. The SEC and the CFTC do that. A consolidated institutional regulator does not establish consumer protection rules like the FSA. A new consumer

agency or the Federal Reserve does that. A consolidated institutional supervisor does not itself have resolution authority or authority with respect to the financial system as a whole. The FDIC does, and perhaps the Fed, the Treasury and a new systemic council would also do that. The consolidate institutional regulator would focus only on the prudential issues applicable to financial institutions like The Office of the Superintendent of Financial Institutions ("OSFI") in Canada and the Australian Prudential Regulatory Authority ("APRA"), both of which have been successful regulators, including during this time of crisis, something I discuss in greater detail below.

- *An Agency That Charters and Supervises National Entities Cannot Regulate Smaller Institutions.* Second, there has been a misconception that a consolidated regulator that regulates enterprises chartered at the national level cannot fairly supervise smaller community organizations. In fact, even today the OCC currently supervises well over 1,000 community-banking organizations whose businesses are local in character. And, it is worth adding that these small, community organizations that are supervised by the OCC, choose this supervision when they clearly have the right to select a state charter with a different supervisory mechanism. The OCC it must also be noted supervises some of the

largest banks in the United States. If the OCC unfairly tilted supervision toward the largest institutions or otherwise, it is hard to imagine that it would have smaller institutions volunteer for its supervision.

- *Entity that Regulates Larger Institutions Cannot Regulate Smaller Institutions.* Third, there is a misconception that a consolidated regulator that regulates larger enterprises cannot regulate smaller enterprises or will tilt the agency's focus in favor of larger enterprises. In fact, whether consolidated or not, all our current financial regulators regulate financial institutions with huge size disparities. Today, all our federal regulators make meaningful accommodations so that they can regulate large institutions and smaller institutions, recognizing that often the business models are different. In fact, as will be discussed in greater detail, it is important to regulate across the size perspective for several reasons. It means the little firms are not second-class citizens with second-class regulation. It means that the agency has regulators sufficiently sophisticated who can supervise complex products that can exist in some smaller institutions as well as larger institutions.

- *Checks & Balances.* Fourth, some have worried that a consolidated institutional supervisor would not have the benefit of other regulatory voices. This would clearly not be the case as a consolidate institutional supervisor would fulfill only one piece of the regulatory landscape. The Federal Reserve, Treasury, SEC, FDIC, CFTC, FINRA, FINCEN, OFAC and FHFA would continue to have important responsibilities with respect to the financial sector. In addition, proposals are being made to add additional elements to the U.S. financial regulatory landscape, the Systemic Risk Council and a new Financial Consumer agency. This would leave 8 financial regulators at the federal level and 50 bank regulators, 50 insurance regulators and 50 securities regulators at the state level. I would think that this is a sufficient number of voices to ensure that the consolidated institutional supervisor is not a lone voice on regulatory matters.

- *Need to Supervise For Monetary Authority And Insurance Obligations.* Fifth, some have also claimed that the primary work of the Federal Reserve (monetary policy, payments system and acting as the bank of last resort) and the FDIC (insurance) would be seriously hampered if they did not have supervisory responsibilities. The evidence does not support these claims.

1. A review of FOMC minutes does not suggest much if any use is made of supervisory data in monetary policy activities. In the case of the FDIC, it has long relied on a combination of publicly available data and examination data from other agencies.

2. There are not now to my knowledge any limitations on the ability of the Federal Reserve or the FDIC to collect any and all information from the organizations they are now supervising, whether or not they are supervising them.

3. And whether or not the Federal Reserve or the FDIC is supervising an entity, it can accompany another agency's examination team to obtain relevant data or review relevant practices.

4. If the FDIC or the Federal Reserve does not have adequate cooperation on gathering information, Congress can make clear by statute that this must be the case.

5. The Federal Reserve's need for data goes well beyond the entities it supervises and indeed where the majority of the financial assets have been located. Hedge funds, private equity funds, insurance companies, mortgage brokers etc. etc. are important areas of the financial economy where the Fed has not gathered data to date and yet these were important areas of the economy to understand in the just ended crisis. Should not these be areas where Federal Reserve Data gathering power are enhanced? Is this not the first order of business? Does the Federal Reserve need to supervise all of these institutions to gather data?

6. Even if the FDIC were not the supervisor of state chartered banking entities, the FDIC would have back-up supervisory authority and be able to be resident in any bank it chose.

7. There is scant information that suggests the Federal Reserve or FDIC's on-site activities, were instrumental in stemming the current crises or bank failures. Again, it is important to emphasize, this is not a reflection on these two exceptional agencies or their extraordinarily

able and dedicated professionals. It is a reflection of our dysfunctional, alphabet soup supervisory structure.

- *No Evidence That Consolidated Supervision Works.* Sixth, some have claimed that because the UK's FSA has had bank failures on its watch, a consolidated institutional regulator does not work and would not work in the U.S. As noted above, the UK FSA is a species of super-regulator with much broader authorities than a mere consolidated regulator. It is also worth noting that neither in the UK nor elsewhere is the debate over supervision one that extols the U.S. model. Rather, the debate tends to be simply over whether the consolidated supervisor should be placed within the central bank or elsewhere.

  More importantly, it should be emphasized that there are regulatory models around the world that have been extremely successful using a consolidated institutional regulator model. Indeed, two countries with the most successful track record through the past crisis, Canada and Australia, have end-to-end, consolidate regulators. In Canada the entity is OSFI and in Australia APRA. Both entities perform essentially the same consolidated institutional prudential supervisory function in their home countries. In both cases they exist in governmental

structures where there are also strong central banks, deposit insurance, consumer protections , separate securities regulators and strong Treasury Departments. Canada and Australia's regulatory systems work very well and indeed, that they have not just a successful consolidated end-to-end supervisor but a periodic meeting of governmental financial leaders that has many of the attributes systemic risk council, discussed below.

- *Would It Do Damage To The Dual Banking System?* Seventh, there was considerable concern in the 1860s and 1870s that a national charter and national supervision would do away with the state banking system. It did not. Similar fears arose when the Federal Reserve and FDIC became a federal examination supervisory component of state-chartered banking. These fears were also unfounded. Both the Federal Reserve and the FDIC are national instrumentalities that provide national examination every other year and more frequently when an institution is troubled. A new consolidated supervisor at the federal level would merely pick up the FDIC and Federal Reserve examination and supervisory authorities.

d. *Proposal.* Accordingly, I strongly urge the Congress to create one financial services institutional regulator. In urging the Congress to take this step, I believe that several matters should be clarified:

- *Institutional Not Market Regulator.* I am not suggesting that we merge the market regulators—the Commodities Futures Trading Commission, the SEC, and FINRA—into this new institutional regulatory mechanism. The market regulators should be allowed to continue to regulate markets—as a distinct functional task with unique demands and delicate consequences. Rather, I am suggesting that all examination, regulation, and enforcement that focus on individual, prudential financial regulation of financial institutions should be part of one highly professionalized agency.

- *Issue is Structure Not People.* As a former U.S. Comptroller of the Currency, who would see his former agency and position disappear into a new consolidated agency, the creation of this new regulator is not a proposition I offer lightly. I fully understand the pride each of our federal financial regulatory agencies takes in its unique history and responsibility. As I have said elsewhere in this testimony, I have nothing but the highest regard for the professionalism and dedication the hard-working men and women who make up these agencies bring to their jobs every day. The issue is not about individuals, nor is it about historic agency successes. Rather, it is all about a system of

regulation that has outlived the period where it can be sufficiently effective. Indeed, perpetuating the current antiquated system makes it harder for the fine men and women of our regulatory agencies to fully demonstrate their talents and to advance as far professionally as they are capable of advancing.

- *Retention of Dual Banking System.* In proposing a consolidated regulatory agency, I am not suggesting that we should do harm to our dual banking system as noted above. Chartering authority is one thing; supervision and regulation are quite another matter. The state charter can and should be retained; the power of the states to confer charters is deeply imbedded in our federalist system. There is nothing to prevent states from examining the institutions subject to their charters. On the contrary, one would expect the states to perform the same regulatory and supervisory functions in which they engage today. As noted, the new consolidated regulatory agency would simply pick up the federal component of the state examination and regulation, currently performed by the Federal Reserve and the FDIC.

- *Funding.* This new consolidated financial institutional regulatory agency should be funded by all firms that it examines, eliminating arbitrage, which often masquerades as attempts to save examination fees.

- *Importance of Independence.* Importantly, this new consolidated supervisory agency needs to be independent. It needs to be a trusted, impartial, professional referee. This is important for several reasons. It is absolutely essential for the agency to be taken seriously that it be free from the possible taint of the political process. It must not be possible for politically elected leader to decide how banking organizations are supervised because of political considerations. Time and again, when the issue of bank supervision and the political process has been considered by Congress, Congress has opted to keep the regulatory mechanisms independent.

  Independence also bespeaks of attracting top talent to head the agency, and this is of considerable importance. If the head of the agency is not someone who is as distinguished and experienced as the head of the SEC, Treasury Secretary or Chairman of the Federal Reserve, if it is not someone with this level of government seniority and distinction, the agency will not function at the level it needs to function to do the kind of job we need in a complex world.

e. *Architecture of Reform Proposals/Congressional Oversight.* Enterprises perform best where they have clear missions, and there are not other missions to add confusion. The consolidated end-to-end supervisor would

have a clear mission and would fit nicely with the proposals below where the roles and responsibilities of all parts of our regulatory system would be simplified and targeted. The Federal Reserve would be in charge of monetary policy, back-stop bank and payments system activities. The FDIC would continue to be the deposit insurer. The SEC and CFTC market regulators. The Systemic Council would identify and seek to mitigate potential systemic events. And a consumer organization would be responsible for consumer issue rule setting.

This allows for much more effective Congressional oversight. Congress will be able to focus on each agency's responsibilities with greater effectiveness when one agency engages in a disparate set of activities.

2. ***Avoid a two-tier regulatory system that elevates the largest "too big to fail" institutions over smaller institutions.***

Eliminating the alphabet soup of regulators should not give rise to a two-class system where our largest banking organizations, deemed "too big to fail", are regulated separately from the rest. To do that has several deleterious outcomes:

a. *Public Utilities or Favored Club.* A two-class system means either the largest institutions become, in essence, public utilities subject to rules—such as higher capital charges, inflexible product and service limitations, and compensation straitjackets -- or, they become a special favored club that siphons off the blue chip credits, the best

depositors, the safest business, the best examiners and supervisory service whereby the community banking sector has to settle for the leftovers. Both outcomes are highly undesirable.

b. *Smaller Institutions Should Not Be Second Class Citizens.* I can assure you that over time, condemning community banking to the leftovers will make them less safe, less vibrant and less innovative. Even today, tens, indeed hundreds of billions of dollars have been used to save larger institutions, even non-banks, and yet we think nothing of failing dozens of community banks. Over 90 banks have failed since the beginning of 2009, and they were overwhelmingly community banks; the number is likely to be in the hundreds before this crisis is over.

c. *Two-Tier Supervisory System Exacerbates "Too Big To Fail" Problem.* Creating a two tier supervisory system and designating some institutions, as "too big to fail" is a capitulation to the notion that some institutions should indeed be allowed to function in that category. To me, this is a terrible mistake. We are enshrining some institutions with such importance due to their size and interconnected characteristics that we are implicitly accepting the notion that our nation's economic wellbeing is in their hands, not in the hands of the people and their elected officials.

d. *Danger of Second Class Supervisory System For Smaller Organizations.* As a practical matter, a two-tier system makes it less likely that top

talent will be available to supervise smaller institutions. At the end of the day, who wants to work for the second regulator that has no ability to ever regulate the institutions that are essentially defined as mattering most to the nation?

e. *Size is Not the Only Differentiating Characteristic.* Finally, just because we might have one prudentially oriented financial services supervisor does not mean that we should not differentiate supervision to fit the size and other characteristics of the institutions being supervised. On the contrary, we should tailor the supervision so that community banks and other kinds of organizations— for example, trust banks or credit card banks — are getting the kind of professional supervision they need, no more and no less. But such an avoidance of a one-size-fits-all supervisory model is far from elevating a class of financial institution into the "too big to fail" pantheon.

- In sum, I urge the Congress not to create a "too big to fail" category of financial institutions, directly or indirectly, either through the regulatory mechanism or by rule. On the contrary, I urge the Congress to take steps to avoid the perpetuation of such a bias in our system.

3. ***It is essential to have a resolution mechanism that can resolve entities, however large and interconnected.***

Essential Nature of the Problem. It cannot be overstressed just how important it is to develop a mechanism to safely resolve the largest and most interconnected financial institutions. If we do not have such a mechanism in place and functioning, we either condemn our largest institutions to become a species of public utility, less innovative and less competitive globally, or we have to create artificial measures to limit size, diversity, and perhaps product offerings. If we choose the first alternative and go the public utility route, we are in effect admitting that some institutions are "too big to fail, and thus unbalancing the rest of our financial services sector. Moreover, adopting either alternative would change not only the fabric of our financial system, but the free-market nature of finance and the economy in the United States.

Complexity of the Undertaking. An essential aspect to eliminating the perception and reality of institutions that are "too big to fail" is to ensure that we have a resolution mechanism that can handle the failure of very large and/or very connected institutions without taking the chance of creating a systemic event. However, it is worth emphasizing that creating such a resolution mechanism will require careful legislative and regulatory efforts. Resolving institutions is not easy.

To step back for a moment, it is quite striking that the seizure of even a relatively small bank, (e.g., a bank with $60 million in assets) is a very substantial undertaking. With the precision of a SWAT team, dozens of bank examiners and

resolutions experts descend on even a small institution that is to be resolved, and they work nearly around the clock for 48 hours, turning the bank inside out as they comb through books and records and catalogue everything from cash to customer files. Imagine magnifying that task to resolve a bank that is 10 times, 100 times or 1,000 times larger than my community bank example.

A Resolution Mechanism Can Be Created to Resolve the Problem. The FDIC has capably discharged its duties as the receiver of even some very large banks, but significantly revised processes and procedures will have to be created to deal with the largest, most interconnected and geographically diverse institutions with broad ranges of product offerings. With that said, having worked both as a director of the FDIC and in the private sector as a lawyer with some bankruptcy experience, I am reasonably confident that we can create the necessary resolution mechanism.

Several aspects to creating a resolution mechanism for the largest banks that deserve particular attention are enumerated below:

a. *Costs Should Not Be Borne By Smaller Institutions.* We have to be careful that the costs of resolution of such institutions are not borne by smaller or healthier institutions, particularly at the time of failure when markets generally may be disrupted. This means all large institutions that might avail themselves of such a mechanism should be paying some fees into a fund that should be available when resolution is needed.

b. *Treasury Backstop.* Furthermore, such a fund should be backstopped by the Treasury as is the FDIC Deposit Insurance Fund ("DIF"). We should not be calling on healthy companies to fill up the fund quickly, particularly during periods of financial turmoil. An unintended consequence of current law is that we have been requiring healthy community banks to replenish the deposit insurance fund during the banking crisis, making matters worse by making the good institutions weaker and less able to lend. We should change current law so that this is no longer the case with respect to the DIF, and this certainly should not be the case with a new fund set up to deal with larger bank and non-bank failures.

c. *Resolution Decisions.* The ultimate decision to resolve at least the largest financial institutions should be the province of a systemic council, which I will discuss in greater detail shortly. The decision should take into account both individual institutional concerns and systemic concerns. Our current legal requirements for resolving the troubled financial system is flawed in that it is one-dimensional, causing the FDIC to make the call on the basis of what would pose the "least-cost to the DIF," not on the basis of the least cost to the economy, or to the financial system. I emphasize that this is not a criticism of the FDIC; that agency is doing what it has to do under current law. My criticism is of the narrowness of the law itself.

d. *Resolution Mechanics.* In terms of which agency should be in charge of the mechanics of resolution itself, there are a number of ways the Congress could come out on this question, all of which have pluses and minuses. Giving the responsibility to the FDIC makes sense in that the FDIC has been engaged successfully in resolving banking organizations and so has important resolutions expertise. One could also argue that the primary regulator that knows the institution best should be in charge of the resolution, calling upon the DIF for money and back up. The primary regulators do in fact have some useful resolutions and conservatorship experiences, though they have not typically been active in the area, in part due to the lack of a dedicated fund for such purposes. Or one could argue for a special agency, like the RTC, perhaps under the control of the new systemic risk council.

I have not settled in my own mind which of these models works best, except to be certain that the institution in charge of resolutions has to be highly professional and that a special process must be in place to deal with the extraordinary issues presented by the failure of an extremely large and interconnected financial institution.

- In sum, I urge Congress to create a new function that can require the resolution of a large, complex financial institution. This new function can be handled as part of the responsibilities of the Systemic Risk Council

discussed below. The mechanism that calls for resolution of a large troubled financial institution need not be the same institution that actually engages in the resolution activity itself. Any of the FDIC, the primary regulator and/or a new resolution mechanism could do the job of actually resolving a large troubled institution if properly organized for the purpose, though certainly much can be said for the FDIC's handling of this important mechanical function, given its expertise in the area generally. Even more important, it is absolutely key that we clarify existing law so that the decision—and the mechanics—to resolve a troubled institution is a question first of financial stability for the system and then a question of least-cost resolution.

4. ***A new systemic risk identification and mitigation mechanism must be created by the federal government; A financial council is best suited to be responsible for this important function.***

Nature of the Problem. The financial crisis we have been living through makes clear beyond a doubt that systemic risk is no abstraction. Starting in the summer of 2007, we experienced just how the rumblings of a breakdown in the U.S. subprime housing market could ripple out to Germany and Australia and beyond. Last year, we witnessed the devastating effects the demise of Lehman Brothers, a complex and interconnected financial company, could have on the financial system and the economy as a whole. The entire

international financial system almost came to a standstill post Lehman Brothers failure.

Notwithstanding the magnitude of the problem and the possible outcomes of a Lehman Brothers failure, our financial regulatory mechanism was caught relatively unaware. For more than a year preceding the Lehman Brothers catastrophe our regulatory mechanism was in denial, considering the problem to be a relatively isolated subprime housing problem.

The same failure to recognize the signs of an impending crisis can be laid at the feet of the regulatory mechanism prior to the S&L crisis, the 1987 stock market meltdown, the banking crisis of the early 1990s, the emerging market meltdown of 1998, and the technology crisis of 2000-2001. No agency of government has functioned as an early warning mechanism, nor adequately mitigated systemic problems as they were emerging.

Only after the systemic problem was relatively full blown have forceful steps been taken to quell the crisis. In some cases the delay in taking action and initial governmental mistakes in dealing with the crisis have cost the nation dearly – as was true in the S&L crisis. The same can be said of the other crises of the preceding century where for example in the case of the Great Depression, steps taken by the Government after the problem arose – to

withdraw liquidity from the market – actually made the problem markedly worse.

Admittedly, identifying potential systemic problems is hard. It involves identifying financial "bubbles," unsustainable periods of excess. However, though difficult, economists outside of government have identified emerging bubbles, including the past one. Furthermore, there are steps that can be taken to mitigate such emerging problems, for example, increasing stock margin requirements or tightening lending standards or liquefying the markets early in the crisis.

The Need to Create a New Governmental Mechanism. This Committee is wisely contemplating the creation of a Systemic Risk Council as a new mechanism to deal with questions of systemic risk. There is general agreement that some new mechanism is needed for identifying and mitigating systemic problems as none exists at the moment.

Indeed, the current Treasury Department has also wisely highlighted the importance of considering systemic risk as one of the issues on which to focus as a central part of financial regulatory modernization. Former Treasury Secretary Paulson, too, who spearheaded Treasury's "blueprint," focused on this important issue. There is now a reasonable consensus that there are times when financial issues go beyond the regulation and supervision of individual financial institutions.

Why A Council In Particular Makes The Most Sense. There are a number of reasons why no current agency of government is suited to be in charge of the systemic risk issue, and why a council with its own staff is the best approach for dealing with this problem.

1. *Systemic Risk: A Product of Governmental Action or Inaction.* It is essential to emphasize that historically, virtually all systemic crises are at their root caused by government action or inaction. Though individual institutional weakness or failure may be the product of these troubled times and may add to the conflagration, the conditions and often even the triggering mechanisms for a systemic crisis are in the government's control.

    i. For example, the decision to withdraw liquidity from the marketplace in the 1930s and the Smoot-Hawley tariffs were important causes of the Great Depression;

    ii. The decision to raise interest rates in the 1980s coupled with a weak regulatory mechanism and expansion of S&L powers led to the S&L failures of the 1980s;

    iii. The decision to produce an extended period of low interest rates, the unwillingness to rein in an over-levered consumer – indeed quite the contrary -- and high liquidity coupled with a

de-emphasis of prudential regulation is at the root of the current crisis.

2. *No Current Regulatory Agency is Well Suited For the Tas*k. Our existing regulators are not well suited, acting alone, to identify and/or mitigate systemic problems. There are a variety of reasons for this.

    a. *Substantial Existing Duties.* First, each of our existing institutions already has substantial responsibilities.

    b. *Systemic Events Cross Existing Jurisdictional Lines.* Second, systemic events often cross the jurisdictional lines of responsibilities of individual regulators, involving markets, sector concentrations, monetary policy considerations, housing policies etc.

    c. *Conflicts of Interest*. Third, the responsibilities of individual regulators can create built-in conflicts of interest, biases that make it harder to identify and deal with a systemic event.

    d. *Systemic Risk Not Fundamentally About Individual Private Sector Institution Supervision.* Fourth, as noted above, it bears emphasis that the actions needed to deal with systemic issues (identification of an emerging systemic crisis, or the conditions

for such a crisis, and then action to deal with the impending crisis) are largely not about supervising individual private-sector institutions.

e. *Systemic Events May Involve Any One Agency's Policies.* Systemic crises may emanate from the polices of an individual financial agency. That has been true in the past. It is hard to have confidence that the same agency involved in making the policy decisions that may bring on a systemic crises will not be somewhat myopic when it comes to identifying the policy law or how to deal with it.

f. *Too Many Duties and Difficulties In Oversight.* There is a legitimate concern that adding a systemic risk function to the already daunting functions of any of our existing financial agencies will simply create a situation where the agency will be unable to perform any one function as well as it would otherwise. Furthermore, Congressional oversight is made considerably more difficult where an agency has multiple responsibilities.

g. *Too Much Concentrated Power*. Giving one agency systemic risk authority coupled with other regulatory authorities moves away

from a situation of checks and balances to one of concentrated financial power. This is particularly true where systemic risk authority is incorporated in an agency with central banking powers. Any entity this powerful goes precisely against the wisdom of our founding fathers, who again and again opposed the centralization of economic power represented by the establishment of the First and Second Banks of the United States, and instead repeatedly insisted upon a system of checks and balances. They were wary, and I believe the current Congress should likewise be wary, of any one institution that does not have clear, simple functional responsibilities, or that is so large and sprawling in its mission and authority that the Congress cannot exercise adequate oversight.

3. *Multiple Viewpoints With Focused Professional Staff.* A Systemic Risk Council of the type contemplated by Committee has the virtue of combining the wisdom and differing viewpoints of all the current financial agencies. Each of these agencies sees the financial world from a different perspective. Each has its own expertise. Combined they will have a more fulsome appreciation of a larger more systemic problem.

Of course, a council alone without a leader and staff will be less effective. To be a major factor in identifying and mitigating a systemic issue, the council will need a strong and thoughtful leader appointed by the President and confirmed by the Senate. That leader will need to have a staff of top economists and other professionals, though the staff can be modest in size and draw on the collective expertise of the staffs of the members of the council.

- Accordingly, I urge Congress to adopt a system whereby the Federal Reserve along with its fellow financial regulators and supervisors should form a council, the board of directors, if you will, of a new systemic risk agency. The agency should have a Chairman & CEO who is chosen by the President and confirmed by the Senate. The Chairman should have a staff:

    - The function of the systemic risk council's staff should be to identify potential systemic events; take actions to avoid such events; and/or to take actions to mitigate systemic events in times of a crisis.

    - Where the Chairman of the systemic council believes he or she needs to take steps to prevent or mitigate a systemic crisis, he or she may take such actions irrespective of the views of the agencies that make up the council, provided a majority of the council agrees.

5. ***Taking additional steps to enhance the professionalization of America's financial services regulatory mechanism should be a top priority.***

   America is blessed with an extremely strong group of dedicated regulators at our current financial services regulatory agencies. However, we must do much more to provide professional opportunities for our fine supervisory people:

   a. As I have said many times before, many colleges and universities in America today offer every conceivable degree except a degree in regulation, supervision, financial institution safety and soundness—let alone the most basic components of the same. Even individual courses in these disciplines are hard to come by.

   b. We should encourage chaired professors in these prudential disciplines.

   c. What I hope would be our new institutional regulatory agency should have the economic wherewithal to provide not just training but genuine, graduate school-level courses in these important disciplines.

   - In sum, we need to further professionalize our regulatory, examination and supervision services, including by way of enhancing university and agency professional programs of study.

6. ***Regulate all financial institutions, not just banks. All financial institutions engaged in the same activities at the same size levels should be similarly regulated.***

   We cannot have a safe and sound financial services regulatory system that has to compete with un-regulated and under-regulated entities that are engaged in virtually identical activities:

   a. It simply does not work to have a large portion of our financial services system heavily regulated with specific capital charges and limits on product innovation, while we allow the remainder of the system to play by different rules. For America to have a safe and sound financial system, it needs to have a level regulatory playing field; otherwise the regulated sector will have a cost base that is different from the unregulated sector, which will drive the heavily regulated sector to go further out on the risk curve to earn the hurdle rates of return needed to attract much needed capital.

   b. In this regard, I want to emphasize that good regulation does not mean a lot of regulation. More is not better; bigger is not better; better is better. Sound regulation does not mean heaping burdens upon currently regulated or unregulated financial players– quite the contrary. I have come to learn after a lifetime of working with the regulatory services agencies that some regulations work well, others do not work and perhaps even more importantly many banks and

other organizations are made markedly less safe where the regulator causes them to focus on the wrong item and/or piles on more and more regulation. Regulators too often forget that a financial services executive has only so many hours in a day. Targeting that time on key safety and soundness matters is critical to achieving a safer institution.

7. ***Protecting consumer interests and making sure that we extend financial services fairly to all Americans must be a key element of any regulatory reform. We cannot have a safe and sound financial system without it.***

We cannot have a safe and sound financial regulatory system that does not protect the consumer, particularly the unsophisticated, nor can we have a safe and sound financial system that does not extend services fairly and appropriately to all Americans.

The Administration has in this regard come out with a bold proposal to have an independent financial services consumer regulator. There is much to commend this proposal. However, this concept has been quite controversial not only among bankers but even among financial services regulators. Why? I think at the center of what gives serious heartburn to the detractors of this concept are three matters that deserve the attention of Congress:

a. First, critics are concerned about the burdens that such a mechanism would create. These burdens are particularly pronounced without a single prudential regulator like the one I have proposed, because without such a change, we would again be adding to our alphabet soup of regulators.

b. Second, I believe critics are justifiably concerned that the new agency would at the end of the day be all about examining and regulating banking organizations and bank-related organizations but not the un- and under-regulated financial services companies, many of which are heavily implicated as causes of the current crisis.

c. Third, there is a concern that the new mechanism will not give rise to national standards but rather, by only setting a national standards floor, will give rise to 50 additional sets of consumer rules, making the operation of a retail banking organization a nightmare.

- For myself, I feel strongly that an independent consumer regulatory agency can only work if these three problems are solved. And I believe they can be solved in a way that improves upon the current situation for all stakeholders. My recommendations follow:

    - *Focus On Un- and Under-regulated Institutions.* First, I would focus a new independent consumer financial regulatory agency primarily on the un- and under-regulated financial services

companies. These companies have historically caused most of the problems for consumers. Many operate within well-known categories—check cashers, mortgage brokers, pay-day-lenders, loan sharks, pawn brokers—so they are not hard to find. It is here that we need to expend the lion's share of examination and supervisory efforts.

- *Minimize Burden.* Second, consistent with my comments on prudential supervision, I would work to have maximum effectiveness for the new agency with minimum burden. In this regard, it is hard to judge such burden unless and until we can see all the financial services regulatory modernization measures. Chairman Dodd and ranking Committee member Shelby, you along with many of your fellow committee members should be commended for waiting to act on any piece of financial services regulatory modernization until we can see the entire package—for precisely these reasons.

- *National Standards for Nationally Chartered Entities.* Third, we need to establish uniform national standards for nationally chartered financial organizations. We are one nation. One of our key competitive advantages as a nation is our large market. We take a big step toward ruining that market for retail finance when we allow every state to set its own standards with its own

enforcement mechanism or entities that have been nationally chartered and are nationally supervised. Do we really want to be a step behind the European Union and its common market? Do we really want to cut up our country so that we are less competitive vis-à-vis other large national marketplaces like China, Canada and Australia? I hope not. I do not think many of the detractors of the current independent consumer agency proposal would continue to oppose the legislation—irrespective of how high the standards are—if the standards are uniform nationally and uniformly examined and enforced.

- *Utilization of Existing Supervisory Teams.* It is worth noting that one way to deal with the burden question that has been suggested by Ellen Seidman, former Deputy to the National Economic Council and former Director of the OTS, is to allow the new agency to set rules and allow the banking agencies to continue to be in charge of examination and enforcement. There is a great deal to say for this approach. However, I am reserving my own views until I see the entire package evolve, absolute musts being for me the three items just mentioned: strict burden reduction, true national standards, and a focus on the un-regulated and under-regulated financial services entities.

Conclusion

In conclusion, Mr. Chairman, I again want to commend you, your colleagues and the committee staff for the serious way in which you have attacked this national problem. The financial crisis has laid bare the underbelly of our economic system and made clear that system's serious vulnerabilities. We are at a crossroads. Either we act boldly along the lines I have suggested or generations of Americans will, I believe, pay a very steep price and our international leadership in financial services will be shattered.

Thank you. I would be pleased to answer any questions you may have.