Testimony of Sheila C Bair

before the

Senate Committee on Banking, Housing and Urban Affairs

Financial Institutions and Consumer Protection Subcommittee

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"A New Regime for Regulating Large, Complex Financial Institutions"

Chairman Brown, Ranking Member Corker, and distinguished members of this Subcommittee:

It is my pleasure to address you today at this hearing entitled "A New Regime for Regulating Large, Complex Financial Institutions".

There is no single issue more important to the stability of our financial system than the regulatory regime applicable to large financial institutions. I would hope that by now there is general recognition of the role certain large, mismanaged institutions played in the lead-up to the financial crisis, and the subsequent need for massive, governmental assistance to contain the damage caused by their behavior. The disproportionate failure rate of large, so-called systemic entities stands in stark contrast to the relative stability of smaller, community banks of which less than 5% have failed. As our economy continues to reel from the financial crisis, with high unemployment and millions losing their homes, we cannot afford a repeat of the regulatory and market failures which allowed this debacle to occur.

There is nothing inherently wrong with size in and of itself. In many business areas, large institutions can achieve significant economies and public benefits. However, size should be driven by market forces, not implied government subsidies. Capital allocation should be determined by investors pursuing sound, innovative business models which promise sustainable returns based on acceptable risk tolerances. It should not be based on highly leveraged bets which promise privatization of benefits but socialization of losses if those bets fail. With the implied government support provided to Fannie Mae, Freddie Mac, and so-called too big to fail financial institutions, the smart money fed the beasts and the smart money proved to be right. As failures mounted, the government blinked and opened up its check book. Creditors and trading partners were made whole. Many executives and board members survived. In most cases, the government didn't even wipe out shareholders before taking exposure.

Implied government subsidies of large financial institutions not only produce an unstable financial system, but they also skew allocation of capital away from other, more stable business sectors. As the charts in the appendix to my testimony show, beginning in the mid-1990's, the assets of financial firms grew much more rapidly than "real economy" assets, with financial firm assets peaking in 2007. Most of this growth was concentrated in the 30 largest institutions. From 2000 to 2008, leverage increased dramatically among large US investment banks and large European and UK institutions. Fortunately, for US commercial banks, leverage remained flat - primarily because the FDIC successfully blocked implementation of the Basel II advanced approaches for setting bank capital. These trends in growth and leverage were not accompanied by increases in traditional lending to support the non-financial sector. Rather, portfolio lending fell significantly as many large financial institutions found trading assets to be much easier and more profitable than going through the hard work of developing and applying sound underwriting standards for loans these large financial institutions planned to keep on their books. Regulators for the most part did not try to constrain these trends, but left the market largely to regulate itself. In some cases, for instance with the repeal of Glass-Steagall and passage of the Commodity Futures Modernization Act, Congress explicitly told the regulators "hands off". As free markets became free-for-all markets, compensation rose, skyrocketing past wages paid to equally skilled employees in other fields. This enticed many of our best and brightest to forego careers in areas like engineering and technology to heed the siren song of quick, easy money from an overheated, over-leveraged financial industry.

In recognition of the harmful effects of too big to fail policies, a central feature of the Dodd-Frank statute is the creation of a resolution framework which going forward will impose losses and accountability on shareholders, creditors, boards, and executives when mismanaged institutions fail. Under Title II of Dodd-Frank, the government can now resolve systemic bank holding companies and nonbank entities using the same time tested tools the FDIC has used to resolve failing banks for decades. Such tools were not available during the 2008 crisis. I am very proud of the fact that the FDIC has already put into place regulations spelling out the process that will be used under Title II to resolve large financial institutions, including making clear the bankruptcy-like claims priority schedule that will impose losses on shareholders and creditors, not on taxpayers. We cannot end too big to fail unless we can convince the market that shareholders and creditors will take losses if the institution in which they have invested fails. For this reason, when I chaired the FDIC, we made the claims priority rules a first order of business after Dodd-Frank was enacted, and I am very pleased that the ratings agencies have begun to remove the "bump up" they assign to the credit ratings of large financial entities based on their previous assumption of government support.

Another central feature of ending too big to fail is the Dodd-Frank requirement that large bank holding companies and nonbank systemic entities submit to both the Federal Reserve Board and the FDIC their resolution plans demonstrating how those financial firms could be resolved in a bankruptcy proceeding during a crisis without systemic disruptions. Rules implementing this so-called "living will" requirement were recently finalized by the FDIC and the FRB, with the first round of living will submissions required of the largest institutions next summer. The Dodd-Frank standard of resolvability in bankruptcy is a very tough one, and my sense is that all of the major banks will need to make significant structural changes to achieve it. In particular, they will need to do much more to rationalize their business lines with their legal entities, which will make it much easier for the FDIC -- or a bankruptcy court -- to hive off and sell healthy operations, while maintaining troubled operations in a "bad bank" which can be worked off over time. Aligning business lines with legal entities will also have important safety and soundness benefits. In particular, it will make it easier for distressed banks to sell operations to either raise capital or wind themselves down absent government intervention. Finally, rationalizing and simplifying legal structures will improve the ability of boards and management to understand and monitor activities in these large banks' far-flung operations. In this regard, I hope regulators will also give some consideration to requiring strong intermediate boards and managers to oversee major subsidiaries. Many of these centralized boards and management do not have a comprehensive understanding of what is going on inside their organizations. This was painfully apparent during the crisis.

One element of Dodd-Frank's living will provision that has not yet been implemented by the agencies is the requirement for credit exposure reports. Credit exposure reports are also required as part of Dodd-Frank's mandate to the Federal Reserve Board to impose heightened prudential standards on large bank holding companies and other systemic entities. Credit exposure reports are essential to make sure regulators understand crucial inter-relationships between distress at one institution and its potential to cause major losses at other institutions. This type of information was missing during the crisis. I know that many members of this Subcommittee heard the same arguments that I heard during the crisis -- that bailouts were necessary or the "entire system" would come down. But we never really had good, detailed information about the derivatives counterparties, bondholders, and others who we were ultimately benefiting from the bailouts and why they needed protecting. For those concerned about the potential "domino" effect of a large bank failure, it is essential not only to identify, understand, and monitor these exposures but also to limit them in advance to contain any possible contagion. I would urge the FDIC and FRB to complete this final piece of the living will rule as soon as possible.

Resolution authority and planning are important to make sure the government is prepared and has the right legal tools to handle a large institution when it fails. And make no doubt; there will always be failures, though hopefully they will be rare. No amount of prudential regulation will be able to eliminate the risk of failures. As I have discussed, resolution authority and planning also entail prophylactic benefits by improving regulatory and management understanding of these large institutions and by giving the investor community stronger incentives to conduct stringent due diligence before committing their investment dollars. A final prophylactic benefit emanates from the harshness of the resolution process, and <u>it is</u> a harsh process, particularly for boards and management who not only lose their jobs but are subject to a two year clawback of all of their compensation. This will give them strong incentives to avoid Title II resolution by raising capital or selling their operations, even if the terms seem unfavorable. More than one commentator has observed that Lehman Brothers' management had multiple opportunities to sell the firm, albeit at punitive pricing, but refused to do so because they thought --

unrealistically -- that their firm was worth more and that. also, the government would come in and provide assistance, as it had with the much smaller Bear Sterns. With Title II, large financial firms now know their fate if they fail, and it is not a pretty one. Bailouts are prohibited and there will be no exceptions. If they can't right their own ship, they will sink with it.

As important as resolution authority is, it obviously cannot substitute for high quality prudential supervision. We must do all that we can to prevent failures while at the same time recognizing that a healthy financial services sector needs reasonable latitude to innovate and take risks. Recognizing that there will always be some measure of risk taking in any profit-making endeavor, it is essential that we make sure our financial institutions have thick enough cushions of capital to absorb unexpected losses when they occur. Excessive leverage was a key driver of the 2008 crisis as it has been for virtually every financial crisis in history. The perils of too much borrowing in creating asset bubbles, and the massive credit contractions that occur once the bubbles pop, have been learned and then forgotten throughout every major financial cycle. These perils were forgotten again in the early 2000's during the so-called golden age of banking when instead of acting to raise capital requirements and implement strong mortgage lending standards, regulators stood by and effectively lowered capital minimums among US investment banks and European institutions through implementation of Basel II.

We need to correct those mistakes through timely implementation of Basle III and the so-called “SIFI surcharges” which taken together, strengthen the definition of high quality capital and also impose risk based ratios as high as 9.5% on our largest institutions. In the near term, given the obvious flaws in the way banks risk-weight assets under Basel II, regulators’ primary focus should be on constraining absolute leverage through an international leverage ratio that is significantly higher than the Basel Committee’s proposed 3% standard. We must also not backtrack on agreements to maintain stringent standards for true tangible common equity. Both Basle III as well as the Collins amendment in Dodd-Frank phase-out the use of hybrid debt instruments for Tier 1 capital because these instruments proved to have no real loss absorbing capacity during the crisis. Fortunately, in the US at least, there seems to be emerging consensus that convertible debt instruments should also not count as Tier 1 capital. I deeply fear that so-called “cocos”, if ever triggered, would likely cause a run on the issuing bank instead of stabilizing it.

Many industry advocates continue to argue that higher capital requirements will inhibit lending. It is true that equity capital is marginally more expensive than debt. This is due, in part, to the "too big to fail" doctrine as well as the favored tax treatment of debt over equity. But this is not a reason to allow them to keep leveraging up. It is fallacy to think that thinly capitalized institutions will do a better job of lending. Throughout the crisis, better capitalized community banks maintained stronger loan balances than their large bank competitors. A large financial institution nearing insolvency will quickly pull credit lines and cease lending to maintain capital. This is why we had such a severe recession. On the other hand, a well capitalized bank will keep functioning even when the inevitable business cycle turns downward. There may be some small, incremental increase in the cost of credit from higher capital levels in good times, but the benefit of stability in bad times more than outweighs those costs.

If there is any question as to why we need strongly capitalized banks, one need look no further than Europe where lax capital regulation has resulted in a highly leveraged banking system that is poorly positioned to absorb losses associated with its sovereign debt crisis. I know some American bank CEOs have complained about the higher capital standards we have in the US – and they are right – in part. Capital regulation is much tougher here and I hope it's going to get even tougher.

But do we want the European banking system? That system is now so fragile it is doubtful that even the strongest banks could raise significant new capital from non-government sources. The choices in Europe are not pretty. They can let a good portion of their banking system fail or they can commit to massive financial assistance through a combination of ECB bond buying and loans and guarantees from the IMF and stronger Eurozone countries. Frankly, I don't know which is worse.

Liquidity is another area which needs more attention from regulators, both in the US and internationally. In the years leading up to the crisis, financial institutions became more and more reliant on cheap, short-term credit, which they would use to fund longer term, illiquid mortgage-related assets. Much of this credit was provided by money market mutual funds. As the market began to lose confidence in the values of those assets, creditors refused to keep extending credit which caused widespread funding shortages. Money market mutual funds in particular took flight at the first sign of trouble to keep from "breaking the buck".

Though financial institutions have made significant progress in extending the average maturities of their liabilities, this has been driven in part by market conditions. We need to put strong rules in place on the liability side of the balance sheet to prevent a recurrence of the liquidity failures of 2008. For instance, we need to dramatically toughen the types of collateral than can be used to secure repos and other short term loans. We should also think about caps on the amount of short term debt that financial institutions can use to fund their balance sheets, as well as the establishment of minimum requirements for the issuance of long term debt. And finally, money market mutual funds should be required to use a floating NAV which should substantially reduce this highly volatile source of short term funding.

A final preventative measure I would like to discuss is the Volcker Rule. The basic construct of the Volcker Rule is one that I strongly support. FDIC insured banks and their affiliates should make money by providing credit intermediation and related services to their customers, not by speculating on market movements with the firm’s funds. However, to some extent this basic construct is at odds with Congress’ 1999 repeal of Glass-Steagall, which allowed insured banks to affiliate with securities firms, and -- let’s be honest -- making money off of market movements is one of the things that securities firms have long done. Recognizing these competing policy priorities, Congress recognized exceptions from the Volcker Rule for traditional securities activities such as market making and investment banking. But the line between these exceptions and prohibited proprietary trading is unclear.

I fear that the recently proposed regulation to implement the Volcker Rule is extraordinarily complex and tries too hard to slice and dice these exceptions in a way that could arguably permit high risk proprietary trading in an insured bank while restricting legitimate market making activities in securities affiliates. I believe that the regulators should think hard about starting over again with a simple rule based on the underlying economics of the transaction, not on its label or accounting treatment. If it makes money from the customer paying fees, interest, and commissions, it passes. If its profitability or loss is based on market movements, it fails. And the inevitable gray areas associated with market making and investment banking should be forced outside of the insured bank and supported by higher capital given the greater risk profile of those activities.

In addition, the new rules should require executives and boards to be <u>personally</u> accountable for monitoring and compliance. Bank leadership needs to make it clear to employees that they are supposed to make money by providing good customer service, not by speculating with the firm's funds.

Complex rules are easy to game and difficult to enforce. We have too much complexity in the financial system already. If regulators can't make this work, then maybe we should return to Glass-Steagall in all of its 32 page simplicity.

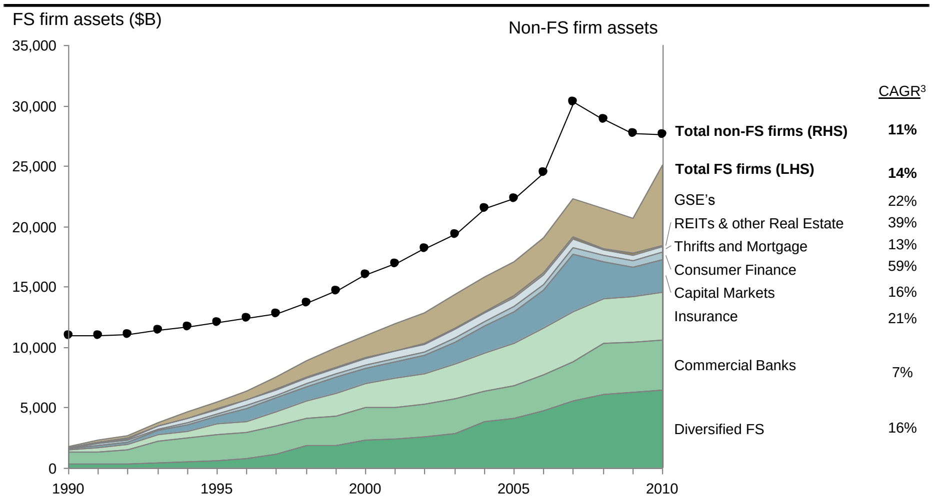
Much work remains to be done to rein in the types of activities undertaken by large financial institutions that caused our 2008 financial crisis. However, through robust implementation of a credible resolution mechanism, strong capital and liquidity requirements, and curbs on proprietary trading, we can once again make our financial system the envy of the world and an engine of growth for the real economy.

That concludes my testimony. Thank you again for the opportunity of testifying.

Appendix:

Financial service firm assets have grown faster than non-financial service firm assets

Total assets for FS firms[1] and non-FS firms[2] (1990 – 2010)

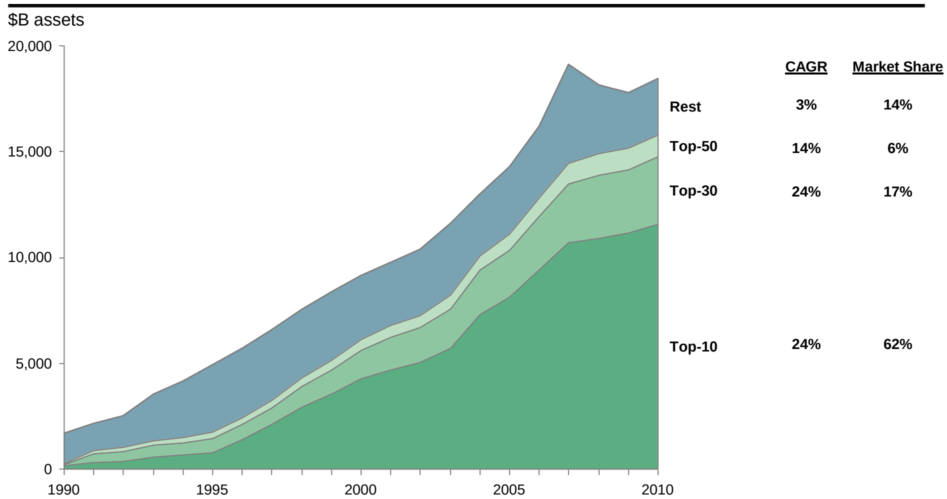


FS / non-FS asset ratio:	**.14**	**.18**	**.20**	**.24**	**.28**	**.29**	**.30**	**.33**	**.32**	**.30**	**.26**	**.26**	**.24**	**.24**	**.22**	**.22**	**.21**	**.18**	**.19**	**.19**	**.23**

1. Includes all publically traded financial service firms as well as GSE's (FICO and FCS excluded due to lack of data). 2. Includes all publically traded non-financial service firms. 3. CAGR stands for compound annual growth rate. Source: Capital IQ.

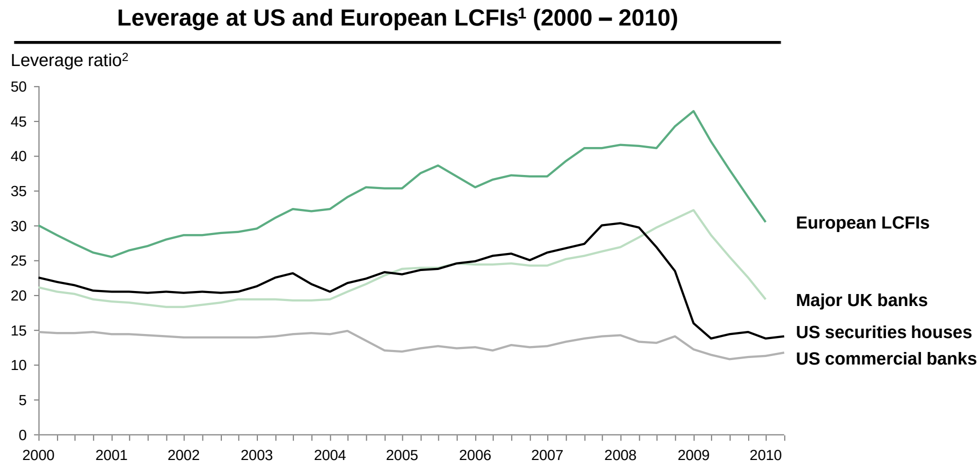
Growth in financial service firm assets has been driven by the largest firms

Total assets for FS firms[1] by size (1990 – 2010)



1. Includes all publically traded financial service firms, but excludes GSEs. Firm size measured by 2010 assets.
Source: Capital IQ.

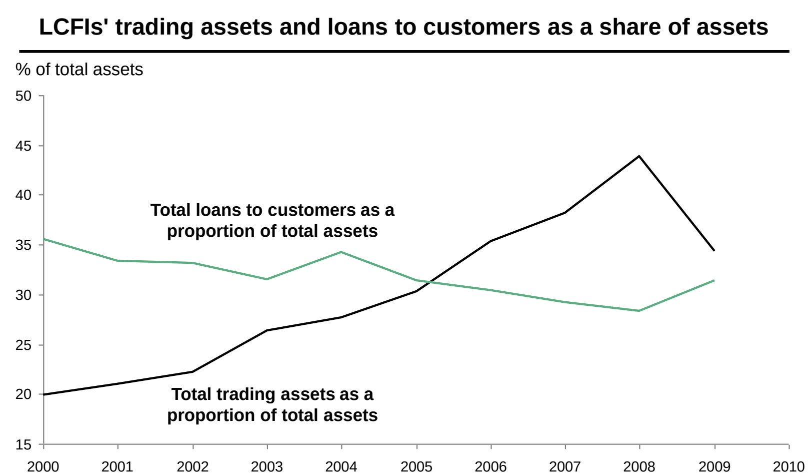
During the 2000s, asset growth was fueled by leverage, both in the US and in Europe



1. LCFI stands for large, complex financial institution.
2. Leverage equals assets over total shareholder equity net of minority interests.

Note: Analysis does not adjust for accounting differences.
Source: Haldane, Brennan, Madouros (2010).

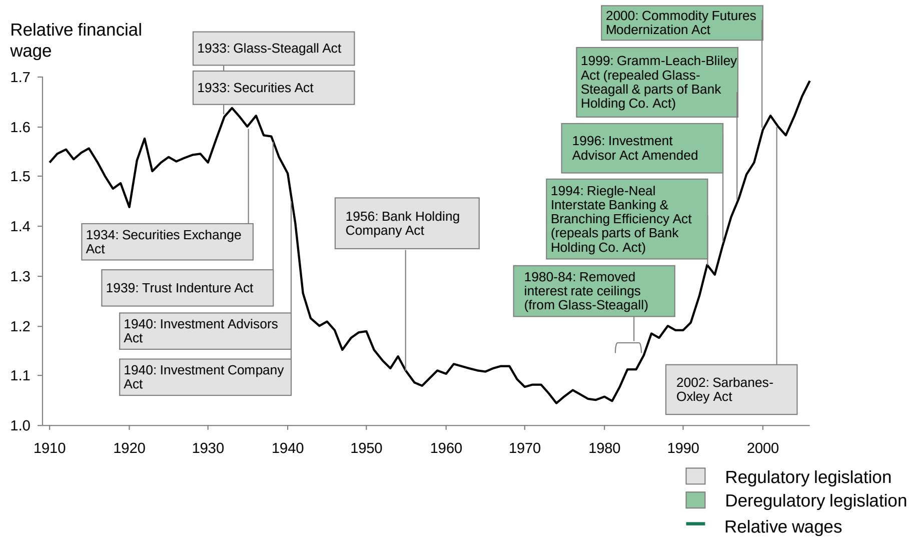
Primarily, asset growth resulted from increases in trading assets and not loans to customers



Note: Includes all US commercial bank LCFIs, European LCFIs, and UK LCFIs.
Source: Haldane, Brennan, Madouros (2010).

FS industry's relative wage responds to regulatory and deregulatory actions

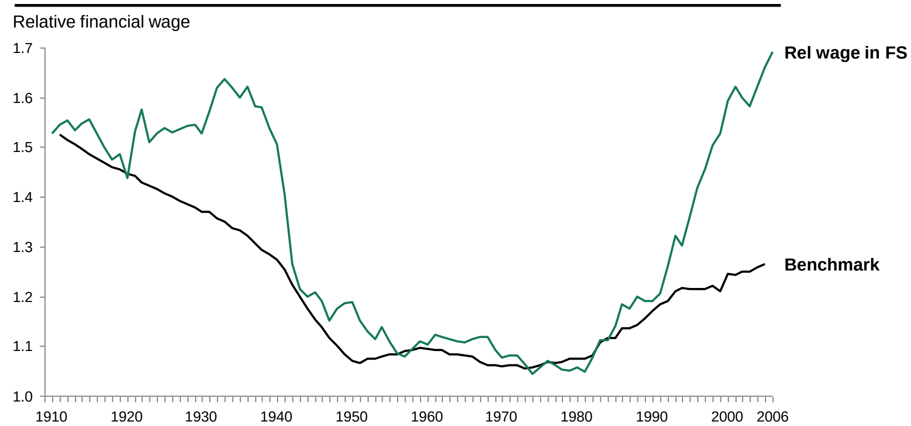
Relative wages in the financial services industry (1910 – 2006)



Note: Relative wage = the ratio of the actual wages in the Financial Sector to the Non Farm Private Sector
Source: "Wages & Human capital in the US Financial Industry: 1909-2006" by Thomas Philippon and Ariell Reshef, December 2008

FS industry wages are high both in a historic sense as well as relative to their estimated benchmark level

Relative wages in the financial services industry (1910 – 2006)



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