Testimony of

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"Enhanced Supervision: A New Regime for Regulating Large, Complex Financial Institutions"

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Chairman Brown, Ranking Member Corker, and Members of the Committee, thank you for the opportunity to testify on the new regime for regulating large, complex financial institutions. I am a professor at the University of Maryland's School of Public Policy and a faculty affiliate of the Center for Financial Policy at the Robert H. Smith School of Business at the University of Maryland. I am also a visiting scholar at the American Enterprise Institute and a senior fellow with the Milken Institute's Center for Financial Market Understanding. I was previously Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009.

Failures in the regulation of large complex financial institutions played an important role in the financial crisis. Many large American financial firms required substantial assistance from the federal government, including capital injections and asset guarantees through the TARP and access to a range of liquidity facilities from the Federal Reserve. At the same time, the main problems in subprime housing that gave rise to the crisis arose outside the most heavily regulated parts of the financial system among non-bank mortgage originators, Fannie Mae and Freddie Mac, and participants in the so-called shadow banking system.

Indeed, a broad view of the crisis shows failures by market participants at all levels of the financial system: sophisticated asset managers who bought sub-prime mortgage-backed securities (MBS) without understanding what was inside or demanding more information; securitizers who put those faulty securities together; rating agencies that stamped them as AAA; bond insurers who covered them; originators who made the bad loans in the first place; mortgage brokers who facilitated the process; and so on, including crucial deficiencies at the Government-Sponsored Enterprises (GSEs) of Fannie Mae and Freddie Mac. (Unfortunately one must also add to the list of failures the actions of some home buyers in providing inaccurate information on mortgage applications or in signing on the dotted line for a house they could not afford—though of course there was someone on the other side of each of these transactions willing to extend the loan.)

Moreover, the severe credit strains that ensued following the failure of Lehman Brothers in September 2008 were made considerably worse by problems in money market mutual funds—large, to be sure, but hardly a complex type of financial institution. The new regulatory regime for large, complex financial institutions is a vital part of lessening the likelihood of future crises, but it is important to keep in mind that there were many contributors to recent events beyond these firms and that an undue focus on this one element risks missing out on others.

Getting the right balance between financial market regulation and dynamism, including the possibility of failure and creative destruction, is an essential element of fostering a more robust economic recovery

and a strong U.S. economy into the future. The slow recovery from the recent recession reflects many factors, including the drag on demand from deleveraging by consumers and firms, the negative impact of policy and regulatory decisions, and the overhang of uncertainty about future taxes, health and energy costs, and so on. But drag from the financial system is likely playing a role as well, with many families and businesses still finding constrained access to credit. While loans were too readily available before the crisis, a danger today is that the pendulum has swung too far in the other direction. The caution of market participants in putting capital at risk could be exacerbated by uncertainty over the impact of ongoing financial regulatory changes. This uncertainty will weigh on the financial sector and the economy.

Detecting and Avoiding Future Problems in the New Regulatory Regime

Regulators did not detect problems in the financial system and act upon the mounting stresses in time to avert the crisis. This reflects failures by the regulators (as was evident in the problems at institutions such as Countrywide, WAMU, IndyMac, and many other firms) and shortcomings and gaps in the regulatory system (as revealed, for example, in the case of AIG, in which no regulator had an adequate line of sight over the activities of the financial products division). This latter problem of the fragmented nature of the U.S. regulatory system was long-understood; indeed, the Treasury Department under the direction of Secretary Paulson in early 2008 put out a thoughtful blueprint to reshape U.S. regulatory system by function.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) includes important provisions that will help avoid future problems and improve the likelihood of detecting them as they arise. Dodd-Frank further provides authorities with tools to deal with severe problems when necessary. The new regulatory regime has the promise of improvement over the one that failed to prevent the recent financial crisis. But much of the change embodied in Dodd-Frank remains to be finalized by regulators, some provisions of the Act do not seem to contribute positively to an improved regulatory regime, and there are still important missing elements in the legislation, notably with respect to reform of the housing finance system and of money market mutual funds.

Improved capital standards and more robust liquidity requirements in both the Dodd-Frank Act and through the Basel III process will help make large, complex financial institutions more robust to losses and thereby help to avoid future crises. While it is hard to imagine that 2 or 4 percentage points of additional capital would have saved Lehman Brothers or Bear Stearns once investors lost confidence in those institutions, more capital will help deepen the buffer in the future before confidence is lost. As discussed below, however, there are costs as well as benefits to increased capital requirements—the challenge for regulators (and for society) is to find the balance.

The establishment of the Financial Stability Oversight Council (FSOC) and the Office of Financial Research (OFR) make it more likely that regulatory authorities will detect building problems. The FSOC in particular will help avoid a repetition of the problems evident in oversight of AIG, where risky activities at one division slipped between the cracks in the sense that no regulator had clear responsibility. Going forward, all systemically important financial institutions will be subject to bank-like regulation. Dodd-Frank further empowers the regulatory agencies acting jointly, but especially the Federal Reserve, to look across firm activities and across industry participants to watch for mounting risks. This will help get at the issue that subprime lending was not necessarily a problem for many individual industry

participants (though it was for some such as Countrywide and WAMU), but subprime lending taken together across firms posed a risk to the financial sector.

The Office of Financial Risk likewise has the potential to help regulators obtain and analyze information across firms and asset classes. Asking for information involves costs, however, and it will be important for the OFR to avoid overly burdensome requests. But the potential is there to help detect systemic risk. Moving forward with a system for a uniform legal entity identifier would help foster greater transparency and allow regulators and firms themselves to better measure and monitor risks. Such transparency can help beyond just immediate tracking of performance because improved availability of information would be expected to affect firms' reputational capital. For example, information that allows investors to more readily link, say, poorly performing loans back to particular originators would provide powerful reputational incentives for better lending performance.

It is impossible to avoid or detect all problems—regulators are only human after all—but these provisions will help.

The benefits of other aspects of the Dodd-Frank Act are less clear in terms of helping to safeguard the financial system against future crises. I would see the so-called Volcker Rule as falling into this category. Proprietary trading does not appear to have a contributing factor in the crisis, and indeed, revenues from this activity helped to offset losses in other areas and thus stabilize some financial firms. It is difficult in practice to distinguish proprietary trading from the normal market-making activities of a broker dealer—a difficulty that is perhaps reflected in the voluminous attempt of the regulatory agencies to define the rule. A poorly-implemented Volcker Rule could reduce liquidity in financial markets and thus raise costs and decrease investment in the broader economy. Indeed, the flat exemption of trading in Treasury securities from the rule illustrates the potential downside. Removing this activity from large financial institutions could have had a meaningful negative impact on demand for Treasury securities and thus lead to increased yields and higher costs for public borrowing. The same concern applies to other activities that will be affected by the rule—all investors and savers will be affected. And investors and savers are not just large, complex financial institutions, but include workers whose pension funds and 401(k)'s invest in these securities. Families will have less access to credit and thus less ability to buy homes, cars, and put children through college. Businesses will find it harder to borrower, which will make it harder for them to do research and development, make capital investments, and create jobs. Asset prices will be pushed down, which will punish investors and savers. It is not clear what problem this rule is meant to solve, making it likely that this aspect of the new regulatory regime for large, complex financial institutions strikes a poor tradeoff between the gains from the regulation and the impairment to markets and overall economic vitality.

The impact of many other provisions is unclear because rules are still to be determined or finalized. The new regime for derivatives, including the increased role for clearinghouses and exchanges in derivative transactions, has the potential to usefully strengthen transparency and thus improve the overall financial regulatory regime, including for large, complex financial institutions. On the other hand, it difficult to understand the benefits of the so-called Lincoln Amendment that requires some derivatives-related activities to be spun off into separately capitalized entities. Part of the value of large financial institutions to markets and the broader economy is the ability to conduct a wide range of transactions, including making markets in derivatives. Indeed, the decision by the Obama administration to exempt the foreign exchange market from these aspects of Dodd-Frank suggests that the administration shares the concern that these provisions likewise do not strike an appropriate balance between the benefits and the costs in terms of diminished economic vitality.

The Benefits of Large Financial Institutions

The tradeoff between increased regulation and economic vitality applies as well to regulations under Section 165 of the Dodd-Frank Act relating to enhanced supervision and prudential standards (many of which are not yet final). Heightened capital requirements provide an increased margin of safety for firms to absorb losses (though this does not necessarily reduce the impact of the failure on the broader financial system once a large firm burns through the added capital). But requiring firms to hold more capital is not free—there is an impact on financial intermediation and thus on the economy that must be kept in mind. Importantly, the empirical evidence is that real-world banks react to binding capital requirements mainly by reducing assets—by making fewer loans—rather than by adding capital. There is a tradeoff, unlike in the theoretical construct in which there are no frictions and a firm's capital structure (the mix of debt and equity in the enterprise) does not matter. In the real world, the tax system favors debt over equity and the bankruptcy system (including the new resolution mechanism discussed below) imposes costs on market participants. These realities are at odds with the assumptions in recent academic work calling for considerably higher capital requirements.

An overly large increase in required capital might impose considerable costs on financial firms and the broader economy without a commensurate increase in financial stability. Banks with very high capital requirements would be less apt to perform the role of providing liquidity services such as through demand deposits and other types of short-term financing. Moreover, increased capital requirements would drive lending activity once again out of the banking system into the less-regulated "shadow banking system." Increased capital would make banks safer, but these firms would no longer perform the functions that society expects of them and risk-taking will migrate outside the regulated banking sector.

The new regulatory regime should also pay attention to the differential impact of financial reforms proceeding at different paces and in various ways across countries. Capital requirements are measured against risk-weighted assets, but financial institutions in Europe (especially) appear to have considerably more aggressive weightings in terms of denoting assets as less risky than is the case in the United States. This means that European firms hold less capital than U.S. competitors with similar assets, thus distorting the competitive balance between firms across borders. This is not to say that the United States should follow Europe in a race-to-the-bottom of lower risk weightings and less capital. The Basel process would be a natural channel through which to ensure that U.S. firms are not disadvantaged.

Similar considerations apply to new liquidity standards, which should take into account the actual characteristics of assets during the recent crisis. GSE securities, for example, have been essentially guaranteed by the federal government since Fannie Mae and Freddie Mac were taken into conservatorship in September 2008 and thus remained liquid throughout the crisis. Advances from the Federal Home Loan Banks (FHLBs) were likewise important sources of liquidity for many U.S. financial institutions during the crisis. Until there is a change in the GSEs or FHLBs, these recent experiences should inform the use of such assets in meeting heightened liquidity requirements.

The process by which large, complex financial institutions will undergo annual capital assessments ("stress tests") has already proved a valuable addition to the prudential regulatory toolkit. The 2009 stress tests, for example, provided an important signal to market participants that key financial institutions would not be nationalized and thus lifted a barrier to renewed private sector investment in financial firms. The key going forward is to develop realistic scenarios against which to test bank

balance sheets. An overly optimistic scenario is not a test, while an unduly pessimistic one could turn into a non-transparent mechanism by which to restrict financial firms' capital distributions—which would ultimately affect firms' ability to attract capital.

Similarly, the process of drawing up so-called living wills could be useful (so long as the undertaking is not extraordinarily burdensome), even though it is inevitable that plans made ahead of time will not be perfectly applicable in a crisis.

The Value of Large, Complex Financial Institutions

The regulatory regime brought about by the Dodd-Frank Act places new burdens on large firms and requires them to hold more capital and have more robust access to liquidity. But the Act does not seek to break up large financial institutions or to reinstitute broader barriers to their activities such as by reinstituting the Glass-Steagall separation of commercial and investment banking. This is appropriate.

The end of the Glass-Steagall restrictions is not well correlated with the failures evident in the recent financial crisis. Bear Stearns and Lehman Brothers both failed, but these firms had remained investment banks. JPMorgan Chase, on the other hand, combined investment banking and commercial banking and yet weathered the strains of the crisis relatively well. The problems revealed by the crisis seem to be in the riskiness of the activities themselves—subprime lending, for example—and not in the combination of commercial and investment banking.

The aftermath of the crisis has meant increased scale for the largest of the surviving institutions. This has both benefits and costs. Among the potential costs are that the failure of a large financial institution could have important impacts on markets and the broader economy. At the same time, there are benefits to the U.S. economy from having large financial institutions, including important advantages to society arising from economies of scope and of scale. A recent study from the Clearing House Association (for which I am a member of the academic advisory committee) discusses and quantifies these benefits.[1] The benefits of scope and scale go together, as banks that are large banks in both size (scale) and footprint (scope) are best able to undertake commercial transactions for large multinational corporations. This reflects the evolution of the globalized economy, as large banks have a relatively strong ability to offer financial products to large customers with specific needs, including in trade finance, global lending, and cash management. Smaller banks can offer these services, but the Clearing House Association study shows that there are benefits to having banks large enough to do them on a scale commensurate with the largest corporate customers.

Similar benefits of scope and scale apply to capital market activities outside of commercial banking, including offering and arranging derivatives-related transactions and investment banking. These benefits reflect the fact that firms with large and diverse balance sheets can best make liquid markets for large transactions and across a broad range of assets. Large financial institutions are best positioned to stand ready as a market-maker to buy and sell assets, including derivatives that allow the beneficial transfer of risk by end-users. Sometimes it is helpful and necessary to have a large balance sheet to put to work. Taken together, the benefits for society through increased economic efficiency resulting from the scale and scope of large banks are estimated at 50 to 100 billion dollars per year.

[1] The study is available on http://www.theclearinghouse.org/index.html?f=073071.

The diversity of small and large institutions and in other dimensions is a feature of the U.S. financial system. Different sizes of U.S. financial institutions stand ready to deal with different types of customers and products. Large banks are essential for firms requiring large amounts of financing—transactions undertaken by large global companies involving multiple billions of dollars of financing. Foreign banking systems are typically far more concentrated than that of the United States—and large foreign banks would stand ready to serve U.S. multinationals in the event that the larger U.S. banks were dismantled. And as with excessive capital requirements, policy actions that diminished the capacities of large U.S. banks could well lead some financial business to move to the less-regulated shadow banking system.

It should be kept in mind that smaller banks present risks—something illustrated in the U.S. savings and loan crisis of the late 1980's and reflected in other countries in the more recent crisis. In Spain, for example, the large banks have been broadly stable (perhaps more so than the sovereign), while smaller and less-diversified financial institutions have been in severe distress.

The diversity of the U.S. financial system is reflected in the different ways that institutions fund themselves. Smaller banks tend to fund their activities using low-cost deposits that benefit from the FDIC guarantee and with FHLB advances that likewise have a federal guarantee. Larger institutions that fund with a greater diversity of sources now pay deposit insurance premiums on non-deposit liabilities even though these liabilities are not actually covered by the FDIC. Larger institutions, especially the so-called globally systemically important banks but also possibly including U.S. banks that are not designated as globally systemic, will face increased capital requirements. The diversity of funding sources is again a strength of the U.S. system; the point here is that it is important to avoid overstating the potential funding advantage of larger financial institutions. This is especially the case going forward with the new resolution authority in the Dodd-Frank Act that makes meaningful changes to the notion that some institutions will be rescued by government action and thus that market participants will be willing to fund these firms at lower costs. This idea of "too big to fail" is discussed next.

Dealing with a Future Financial Crisis: Resolution Authority

The Title II resolution authority will have important effects on large, complex financial institutions and on the providers of funding to these institutions. For bondholders and other non-deposit funders, the Dodd-Frank resolution authority puts them on notice that they should expect to take losses in the event that a firm fails and is taken into resolution. Resolution authority could well involve the deployment of government resources (later to be repaid by market participants) to support a firm and slow its demise. But the outcome is virtually certain to involve losses for bondholders, unlike what generally happened during the crisis.

For better or worse, the Title II authority will be used in the event that a large complex financial institution fails. After all, it is difficult to imagine another TARP facility to intervene in the financial sector. The authorities in Title II give government officials some TARP-like ability to put money into failing firms, and the experience of the recent crisis is that policymakers are likely to use these authorities to avoid the full impact of the collapse of a large systemically significant firm. This likelihood in turn will affect the behavior of market participants today. In this way, Title II makes for a profound change in the regulatory environment facing large, complex financial institutions, including a meaningful change from the past belief that institutions were too big to fail.

It is hard to know precisely how the resolution authority will be used, notably because the authority is likely to be exercised in a time of broad financial market stress when regulators face a variety of

challenges. For making changes to the concept of too big to fail, what matters most is the ability of the FDIC in undertaking the resolution to make ex-post clawbacks from bondholders to cover losses after shareholder equity is wiped out. Indeed, the FDIC has been clear that bondholders should not expect to get additional payments through use of the Dodd-Frank resolution authority—it is more likely the opposite. This can take place even if the FDIC initially uses government funds to keep a firm in operation in resolution—this might occur, for example, if the FDIC seeks to preserve the "franchise value" of a large firm while it arranges a sale of the firm or of components to new owners. Another possible outcome is that the FDIC uses the Title II authorities to arrange a debt-for-equity swap that recapitalizes the failing firm (or perhaps some parts of it) in a new form and with new management and shareholders (namely, the former bondholders). Such a debt-for-equity recapitalization would be similar to a pre-packaged Chapter 11 reorganization under the bankruptcy code, though the Title II authorities would allow this to be done faster and with funding provided by the government (though eventually paid back by private market participants). It should be noted that much of this was already possible with the regular bankruptcy process and that it remains an open question as to whether Title II will make policymakers more likely to intervene in markets. That is, Title II could help limit the notion of too big to fail but give rise to more government interference that has other negative impacts on the economy.

The key element for addressing too big to fail is that bondholders take losses. This is likely to be the case, given that the ability to do this is clear in the legislation. In contrast to the resolution of WAMU by the FDIC in the fall of 2008, the imposition of (possibly substantial) losses will not be a surprise to bondholders and therefore should not cause massive spillover effects that adversely impact the ability of other firms to fail. The key is that Title II makes clear that bondholders will take losses.

It must be kept in mind that there are other, possibly troublesome, effects from the new authority. The certainty of losses in resolution will give providers of funding to banks an incentive to flee at early signs of trouble. This sort of run from failing institutions is an important disciplining device, but the regime change could mean a more hair trigger response than previously and thus inadvertently prove destabilizing. This would be the case if market participants move away from long-term funding of financial institutions because of the increased possibility of losses.

The ability of policymakers to deploy public resources in the resolution process also gives rise to concerns that firms taken into resolution could be used for policy purposes. Losses to the government are ultimately borne ex-post by the bondholders once the equity of the firm is exhausted, which seems likely to be the case. The legislation seeks to narrow the scope of action for the FDIC in resolution by guaranteeing bondholders that they will receive as much in resolution as would have been the case under bankruptcy, but this still gives scope for actions to use the firm under resolution. In a sense, the resolution authority provides government officials with an open checkbook to act through the troubled firm, with bondholders picking up the tab. This is not an empty concern; witness, for example, efforts to have the GSEs undertake loss-making policy activities which would then be offset by new capital injections from the Treasury. The funds under Title II would come first from bondholders and then from assessments on other market participants rather than from taxpayers, but the concern is over the ability of the government to act and transfer resources without a vote of the Congress. This concern remains even if it bondholders on the hook rather than taxpayers.

Finally, the resolution authority will be incomplete and perhaps unworkable until there is more progress on the international coordination of bankruptcy regimes.

Conclusion

The new regulatory regime for large, complex financial institutions will be a vast change from the system before the financial crisis. Important aspects of the change are for the good, including changes that address the phenomenon under which some firms were too big to fail. But there is still much that is unclear in the workings of the new regulatory regime and much rulemaking to be done.

It is important to keep in mind that many of the changes will involve costs as well as benefits. Higher capital and liquidity requirements, for example, will impose costs on financial institutions that will affect lending activity and thus the overall economy. Changes are still desirable in the wake of the crisis; the key is to be cognizant of the tradeoffs involved and avoid regulatory requirements that provide inadequate benefits relative to the costs involved.

This tradeoff applies to discussions about the role of large, complex financial institutions in the U.S. financial system and the broader economy. These institutions provide important benefits for financial markets and for the economy. Changes that lessen their role or impair their functioning would have meaningful costs to society.

Finally, there are important aspects of financial regulatory reform that were not accomplished in the Dodd-Frank legislation and that pertain to the regulatory regime for large, complex financial institutions. The unfinished business of regulatory reform notably includes the future of the housing finance system, including Fannie Mae and Freddie Mac, reforms to money market mutual funds, and changes to the oversight of broader aspects the collateralized lending that takes place in the so-called shadow banking system. If anything, some provisions of Dodd-Frank could make the shadow banking system larger as activities migrate (or are forced to migrate) out of the more heavily regulated large financial institutions.