

STRENGTHENING AND STREAMLINING PRUDENTIAL BANK SUPERVISION

HEARING

BEFORE THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

STRENGTHENING AND STREAMLINING PRUDENTIAL BANK SUPER-
VISION TO BETTER PROVIDE THE SAFETY, SOUNDNESS, AND STA-
BILITY OF THE FINANCIAL MARKETS

AUGUST 4 AND SEPTEMBER 29, 2009

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C O N T E N T S

TUESDAY, AUGUST 4, 2009

	Page
Opening statement of Chairman Dodd	1
Opening statements, comments, or prepared statements of:	
Senator Johnson	
Prepared statement	43
Senator Reed	
Prepared statement	43

WITNESSES

Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation	2
Prepared statement	44
Responses to written questions of:	
Senator Bunning	79
John C. Dugan, Comptroller of the Currency, Office of the Comptroller of the Currency	4
Prepared statement	48
Responses to written questions of:	
Senator Bunning	82
Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System	5
Prepared statement	66
Responses to written questions of:	
Senator Bunning	89
John E. Bowman, Acting Director, Office of Thrift Supervision	7
Prepared statement	72
Responses to written questions of:	
Senator Bunning	90

TUESDAY, SEPTEMBER 29, 2009

Opening statement of Chairman Dodd	99
Prepared statement	132

WITNESSES

Eugene A. Ludwig, Chief Executive Officer, Promontory Financial Group, LLC	101
Prepared statement	132
Martin N. Baily, Senior Fellow, Economic Studies, The Brookings Institution ..	104
Prepared statement	144
Richard S. Carnell, Associate Professor, Fordham University School of Law	107
Prepared statement	153
Richard J. Hillman, Managing Director, Financial Markets and Community Investment Team, Government Accountability Office	109
Prepared statement	159

STRENGTHENING AND STREAMLINING PRUDENTIAL BANK SUPERVISION

TUESDAY, AUGUST 4, 2009

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

The Committee met at 9 a.m. in room SD-538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order. Let me welcome our guests who are in the hearing room this morning, as well as to welcome our very distinguished panel of witnesses, and we thank the four of you and the second panel that is going to come as well.

I have informed our colleagues already, those who are here, and others, we are under some time constraints. We have a couple of votes around 10:30 that are coming up on the floor of the Senate. There is a meeting that we are going to have that begins a little after noon that many of us are going to have to attend later. So we are not going to make any opening statements, including the Chairman and the Ranking Member. We have agreed this morning just to get right to our witnesses.

I know my colleague from Tennessee would like that precedent, I tell you. He has been dying for that moment for 2 years.

[Laughter.]

Senator SHELBY. Mr. Chairman, when he was mayor, nobody spoke.

Chairman DODD. No, no. Just the mayor spoke. We are not setting precedent here, but we are certainly going to, this morning, move in that direction.

So let me thank again everyone for being with us this morning. Obviously, strengthening and streamlining prudential bank supervision is a major subject matter. We have had I do not know how many hearings. What is the number? Twenty-eight hearings since January on this subject matter of financial modernization regulations. And, obviously, this is a very critical piece to the extent we are going to have consolidation of our financial regulators.

And so I welcome our witnesses here this morning. Many—well, all of you have been before us on numerous occasions to talk about the various aspects of the financial troubles our Nation has been in over the last number of years. And I just want to make one point, and I know all of you at the table pretty well, and I know

you understand this because I believe you care about this as well. Our job, obviously, here is not to protect regulators. Our job is, obviously, to protect the people who count on us and you and the system to provide the safety and soundness and the stability of the financial markets. That is what this is all about. And I know you get that and understand that, but I sometimes think we need to clear the air a little bit to make sure people understand what we are talking about as we describe the structure and the architecture that will provide that sense of stability and safety and soundness that we are looking for.

So, with that, let me just turn directly, if I can, to you, Sheila, to start in on this. I will ask you to try and be brief. Again, all the documents and all of my colleagues' opening statements will be included in the record at this point here.

We will try and be a little more careful on the clock than we might otherwise be because of time constraints.

Jim, I am just explaining we have got some votes in an hour and a half or so. We are going to try and move along to the extent possible.

Sheila, we thank you again for being with us.

STATEMENT OF SHEILA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Thank you, Senator Dodd, Ranking Member Shelby, and Members of the Committee. Today you have asked us to address the regulatory consolidation aspects of the Administration's proposal and whether there should be further consolidation.

The yardstick for any reform should be whether it deals with the fundamental causes of the current crisis and helps guard against future crises. Measured by that yardstick, we do not believe the case has been made for regulatory consolidation of State and Federal charters.

Among the many causes of the current crisis, the ability to choose between a State and Federal charter was not one of them. As a consequence, we see little benefit to regulatory consolidation and the potential for great harm and its disruptive impact and greater risk of regulatory capture and dominance by large banking organizations.

The simplicity of a single bank regulator is alluring. However, such proposals have rarely gained traction in the past because prudential supervision of FDIC-insured banks has, in fact, worked well compared to the regulatory structures used for other U.S. financial sectors and to those used overseas. Indeed, this is evidenced by the fact that large swaths of the so-called "shadow banking sector" have collapsed back into the healthier insured sector.

And U.S. banks, notwithstanding the current problems, entered this crisis with stronger capital positions and less leverage than their international competitors.

A significant cause of the crisis was the exploitation of regulatory gaps between banks and the shadow nonbank financial system and virtually no regulation of the over-the-counter derivatives contracts. There were also gaps in consumer protection. To address these problems, we have previously testified in support of a systemic risk council that would help assure coordination and harmo-

nization of prudential standards among all types of financial institutions.

And a council would address regulatory arbitrage among the various financial sectors.

We also support a new consumer agency to assure strong rules and enforcement of consumer protection across the board. However, we do not see merit or wisdom in consolidating all Federal banking supervision. The risk of weak or misdirected regulation would be exacerbated by a single Federal regulator that embarked on a wrong policy course. Prudent risk management argues strongly against putting all your regulatory and supervisory eggs in one basket.

One of the advantages of multiple regulators is that it permits diverse viewpoints to be heard. For example, during the discussion of Basel II, the FDIC voiced deep and strong concerns about the reduction in capital that would have resulted. Under a unified regulator, the advanced approaches of Basel II could have been implemented much more quickly and with fewer safeguards, and banks would have entered this crisis with much lower levels of capital.

Also, there is no evidence that shows a single financial regulatory structure was better at avoiding the widespread economic damage of the past 2 years. Despite their single-regulator approach, the financial systems in other countries have all suffered during the crisis.

Moreover, a single-regulator approach would have serious consequences for two mainstays of the American financial system: the dual banking system and deposit insurance. The dual banking system and the regulatory competition and diversity that it generates is credited with spurring creativity and innovation in financial products and the organization of financial activities. State-chartered institutions tend to be community-oriented and very close to the small businesses and customers they serve. They provide the funding that supports economic growth and job creation, especially in rural areas. Main Street banks also are sensitive to market discipline because they know they are not too big to fail and that they will be closed if they become insolvent.

A unified supervisory approach would inevitably focus on the largest banks to the detriment of community banking. In turn, this could cause more consolidation in the banking industry at a time when efforts are underway to reduce systemic exposure to very large financial institutions and to end "too big to fail."

Concentrating examination authority in a single regulator also could hurt bank deposit insurance. The loss of an ongoing and significant supervisory role would greatly diminish the effectiveness of the FDIC's ability to perform a congressional mandate. It would hamper our ability to reduce systemic risk through risk-based premiums and to contain the costs of deposit insurance by identifying, assessing, and taking actions to mitigate risk to the Deposit Insurance Fund.

To summarize, the regulatory reforms should focus on eliminating the regulatory gaps I have just outlined. Proposals to create a unified supervisor would undercut the many benefits of our dual banking system and would reduce the effectiveness of deposit in-

surance, and, most importantly, they would not address the fundamental causes of the current crisis.

Thank you.

Chairman DODD. Thank you very much, and I apologize, Sheila, for not properly introducing you here as the Chairperson of the Federal Deposit Insurance Corporation. I kind of assume everybody knows who you are, so I kind of jumped into that, and I apologize.

John Dugan is the Comptroller of the Currency, and we thank you very much, a well-known figure to this Committee, having served on this side of the dais for a number of years and now at the OCC. So we thank you, John.

STATEMENT OF JOHN C. DUGAN, COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. DUGAN. Thank you very much, Mr. Chairman.

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I appreciate this opportunity to discuss the Administration's proposal for regulatory reform.

The OCC supports many elements of the proposal, including the establishment of a council of financial regulators to identify and monitor systemic risk and enhanced authority to resolve systemically significant financial firms. We also believe it would be appropriate to establish a consolidated supervisor of all systemically significant financial firms.

The Federal Reserve already plays this role for the largest bank holding companies, but during the financial crisis, the absence of a comparable supervisor for large securities and insurance firms proved to be an enormous problem. The proposal would fill this gap by extending the Federal Reserve's holding company regulation to such firms, which we believe would be appropriate.

However, one aspect of the proposal goes much too far, which is to grant broad new authority to the Federal Reserve to override the primary banking supervisor on standards, examination, and enforcement applicable to the bank. Such override power would fundamentally undermine the authority and accountability of the banking supervisor.

We also support the proposal to effectively merge the OTS into the OCC with a phase-out of the Federal Thrift Charter. My written testimony responds in detail to the Chairman's questions about options for additional banking agency consolidation by: first, establishing either the Federal Reserve or the FDIC as the single Federal agency responsible for regulating State-chartered banks; second, establishing a single prudential supervisor to supervise all national and State banks; and, third, transferring all holding company regulation from the Federal Reserve to the prudential supervisor.

While there are significant potential benefits to be gained from all three proposals, there are also potential costs, especially with removing the Federal Reserve altogether from the holding company regulation of systemically important companies.

Finally, we support enhanced consumer financial protection standards and believe that a dedicated consumer protection agency could help to achieve that goal. However, we have significant concerns with the parts of the proposed CFPA that would consolidate

all financial consumer protection rulewriting, examination, and enforcement in a single agency which would completely divorce these functions from safety and soundness regulation.

It makes sense to consolidate all consumer protection rulewriting in a single agency with the rules applying to all financial providers of a product, both bank and nonbank. But we believe the rules must be uniform and that banking supervisors must have meaningful input into formulating them. Unfortunately, the proposed CFPA falls short on both counts.

First, the rules would not be uniform because the proposal would expressly authorize States to adopt different rules for all financial firms, including national banks, by repealing the Federal preemption that has always allowed national banks to operate under uniform Federal standards. This repeal of a uniform Federal standards option is a radical change that will make it far more difficult and costly for national banks to provide financial services to consumers in different States having different rules, and these costs will ultimately be borne by the consumer. The change will also undermine the national banking charter and the dual banking system that have served us well for nearly 150 years.

Second, the rules do not afford meaningful input from banking supervisors, even on real safety and soundness issues, because in the event of any disputes, the proposed CFPA would always win. The new agency needs to have a strong mechanism for ensuring meaningful bank supervisor input into CFPA rulemaking.

Finally, the CFPA should not take examination and enforcement responsibilities away from the banking agencies. The current bank supervisory process works well where the integration of consumer compliance and safety and soundness supervision provides real benefits for both functions. Moreover, moving bank examination and enforcement functions to the CFPA would only distract it from its most important and daunting implementation challenge—that is, establishing an effective enforcement regime for the shadow banking system of the literally tens of thousands of nonbank providers that are currently unregulated or lightly regulated, like mortgage brokers and originators. The CFPA's resources should be focused on this fundamental regulatory gap rather than on already regulated depository institutions.

Thank you very much.

Chairman DODD. Thank you very much.

Dan Tarullo, from the Federal Reserve Board, we thank you, Dan, once again for coming before the Committee. Happy to hear your testimony.

STATEMENT OF DANIEL K. TARULLO, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. TARULLO. Thank you, Mr. Chairman, Ranking Member Shelby, and other Members of the Committee.

Before the final history of the financial crisis is written, I am certain that supervisory shortcomings in all kinds and sizes of financial institutions, will have been revealed. The crisis has also shown that the framework for prudential supervision and regulation has not kept pace changes in the structure, activities, and interrelationships of the financial sector.

In my prepared testimony, I have suggested and tried to elaborate the elements of an effective framework for prudential supervision, including a number of recommendations for legislative actions. Knowing of your time constraints this morning, let me confine these introductory remarks to three quick points.

First, prudential supervision must be required for all systemically important institutions. It is noteworthy that a number of the firms at the heart of the crisis had not been subject to mandatory prudential supervision of any sort. Improving the quality of supervision will fall short of realizing the maximum potential gains for financial stability if important institutions can escape the rules and requirements associated with the supervisory process.

Second, there must be effective supervision of the companies that own insured depository institutions, a task that is distinct from the supervision of the banks themselves. Large organizations increasingly manage their businesses on an integrated basis, with little regard for the corporate boundaries that typically define the jurisdiction of individual functional supervisors. There is need for close scrutiny of the linkages between the banks and other affiliates within a holding company—not just straightforward financial or contractual ties, but also managerial, operational, and reputational linkages. The premise of so-called “functional regulation”—that risks within a diversified organization can be successfully evaluated and controlled through supervision within each individual firm—has been belied by the experience of the financial crisis.

Third, it is important to emphasize that much of what needs to be done to improve and adapt our system of prudential supervision lies within the existing authorities of the agencies represented at this table. Together, we have acted to shut down the practice of converting charters in order to escape enforcement actions or adverse supervisory ratings. We are working together in international fora to assure that all internationally active financial institutions are subject to effective regulation. The Federal Reserve is adjusting its approach to prudential supervision, particularly of the largest banking organizations.

Building on the experience of the unprecedented Supervisory Capital Assessment Program, or SCAP, we are expanding our use of horizontal examinations to assess key operations, risks, and risk management of large institutions. We are creating an enhanced quantitative surveillance mechanism that will draw on a multidisciplinary group of economists and other experts to create and evaluate scenarios that cross large firms. These top-down analyses will provide an independent supervisory perspective on the bottom-up work of supervisory teams. The two perspectives will be joined in a well-coordinated process involving both the supervisory teams and Washington staff.

Thank you all for your attention. I look forward to discussing both agency and congressional initiatives to strengthen further our prudential supervisory system.

Chairman DODD. Thank you very much, Governor.

I will now turn to our last witness, John Bowman, who is the Acting Director of the Office of Thrift Supervision. John, we welcome you once again to the Committee.

**STATEMENT OF JOHN E. BOWMAN, ACTING DIRECTOR,
OFFICE OF THRIFT SUPERVISION**

Mr. BOWMAN. Good morning, Chairman Dodd, Ranking Member Shelby, and other Members of the Committee. Thank you for the opportunity to testify on the Administration's proposal for financial regulatory reform. It is my pleasure to address this Committee for the first time in my role as Acting Director of the Office of Thrift Supervision. I will begin my testimony by outlining the core principles I believe are essential to accomplishing true and lasting reform. Then I will address specific questions you asked regarding the Administration's proposal.

Let me start with the four principles.

One, ensure that changes to the financial regulatory system address real problems. We all agree that the system has real problems and needs real reform. What we must determine, as we consider each proposed change, is whether the proposal would fix what is broken. In the rush to address what went wrong, let us not try to fix nonexistent problems or try to fix real problems with flawed solutions.

Two, ensure uniform regulation. One of the biggest lessons learned from the current economic crisis is that all entities offering financial products to consumers must be subject to the same rules. Underregulated entities competing in the financial marketplace have a corrosive, damaging impact on the entire system. Also, complex derivative products such as credit default swaps should be regulated.

Three, ensure that systemically important firms are effectively supervised and, if necessary, wound down in an orderly manner. No provider of financial products should be too big to fail, achieving through size and complexity an implicit Federal Government guarantee to prevent its collapse. The U.S. economy operates on the principle of healthy competition. Enterprises that are strong, industrious, well managed, and efficient succeed and prosper. Those that fall short of the mark struggle or fail, and other stronger enterprises take their places. Enterprises that become too big to fail subvert the system. When the Government is forced to prop up failing systemically important companies, it is, in essence, supporting poor performance and creating a moral hazard.

Let me be clear. I am not advocating a cap on size, just effective, robust authority for properly regulating and resolving the largest and most complex financial institutions.

Number four, ensure that consumers are protected. A single agency should have the regulation of financial products as its central mission. That agency should establish the rules and standards for all consumer financial products, regardless of the issuer of those products, rather than having multiple agencies with fragmented authority and a lack of singular accountability.

Regarding feedbacks on the questions the Committee asked, the OTS does not support the Administration's proposal to eliminate the Office of the Comptroller of the Currency and the Office of Thrift Supervision, transferring the employees of each into a national bank supervisory agency or for the elimination of the Federal Thrift Charter. Failures by insured depository institutions have

been no more severe among thrifts than among institutions supervised by other Federal banking regulators.

If you look at the numbers of failed institutions, most have been State-chartered banks whose primary Federal regulator is not the OTS.

If you look at the size of failed institutions, you see that the Federal Government prevented the failures of the largest banks that collapsed by authorizing open bank assistance. These too-big-to-fail institutions are not and were not regulated by the OTS.

The argument about bank shopping for the most lenient regulator is also without merit. Most financial institutions and more assets have converted away from OTS supervision in the last 10 years than have converted to OTS supervision.

In the same way the thrift charter is not part of the problem, we do not see any reason to cause major disruptions with the hundreds of legitimate, well-run financial businesses that are operating successfully with the thrift charter and making credit available to American consumers. My written testimony contains detailed information you requested about the proposed elimination of the exceptions in the Bank Holding Company Act for thrifts and certain special-purpose banks and about the Federal Reserve System's prudential supervision of holding companies.

Thank you again, Mr. Chairman, and I would be happy to answer any questions.

Chairman DODD. Thank you very much, Mr. Bowman.

Let me ask the clerk to put the clock on here for about 6 minutes per Member, and I have two questions I want to raise with you, if time permits, and then I will turn to Senator Shelby.

First of all, for decades—and I have been on this Committee for a number of years, and we have had commissions and think tanks and regulators, presidents, Banking Committee Chairs. John, you will remember sitting behind us back here at that table with parties recommending the consolidation of Federal banking supervision. Bill Proxmire, who sat in this chair for a number of years, proclaimed the U.S. system of regulation to be, and I quote, “the most bizarre and tangled financial regulatory system in the world.”

Former FDIC Chairman, Sheila, Chairman William Seidman, called it “complex, inefficient, outmoded, and archaic.”

In the wake of the last bank and thrift crisis, when hundreds of institutions failed, the Clinton administration urged Congress to consolidate the Federal banking regulators into a single prudential regulator. So here we have seen Administrations, Chairs of this Committee, and others over the years, all at various times, in the wake of previous crises, call for consolidation, and yet we did not act after those crises. We sat back and basically left pretty much the system we have today intact. And as a result, we have had some real costs ranging from inefficiencies and redundancies to the lack of accountability and regulatory laxity. We are now paying a very high price for those shortcomings.

So my first question is—the Administration, as you all know and you have commented on, has proposed the consolidation of the OCC and OTS, but leaves in place the three Federal bank regulators. My question is simply: Putting the safety and soundness of the banking system first, is the Administration proposal really enough? Or

should we not be listening to the admonition of previous Administrations? And people have sat in this chair who have recommended greater consolidation that ought to be the step taken.

Sheila, we will begin with you.

Ms. BAIR. As I indicated in my opening statement, we do not think that the ability to choose between the Federal and State charter was any kind of a significant driver or had any kind of an impact at all on the activities that led to this current crisis. The key problems were arbitrage between more heavily regulated banks and nonbanks, and then the OTC derivatives sector, which was pretty much completely unregulated.

I do support merging OCC and OTS. That is reflective of market conditions, but that doesn't need to be about whether there is a weak regulator or strong regulator. I think that is just a reflection of the market and the lack of current market interest in a specialty charter to do just mortgage lending or heavily concentrate on mortgage lending. In fact, some of the restrictions on the thrift charter perhaps have impeded the ability of those thrifts to undertake additional diversification.

So, Mr. Chairman, I would have to respectfully disagree in terms of drivers of what went on this time around. I really do not see that as a symptom of the fact that you have four different regulators overseeing different charters for FDIC-insured institutions. And I do think that the banks held up pretty well compared to the other sectors. They did have higher capital standards and more extensive regulation.

Chairman DODD. Let me just ask you and the other panelists to comment on this. Clearly, we are looking back in the rearview mirror as to what happened, and that is certainly a motivation here. But it is not the sole motivation. It is not just a question of addressing the problems that occurred, but going forward, in the 21st century, in a very different time, in a global economy today—we saw the implications of what happened not only here in this country but around the world. The idea that we would maintain the same architecture we have for decades is not only a question about what has occurred and whether or not the system responded well enough to it, but looking forward as to whether or not this architecture and structure is going to be sufficient to protect the safety and soundness in a very different economic environment than existed at the time these agencies emerged through the process of growth over the years. It seems to me that is just as important question as looking back.

Ms. BAIR. I think it is a very important question, and I am very glad you are having these hearings. But I do not think that this is going to solve the problems that led to this crisis. Looking at the performance of other models in European countries that have a single regulator, the performance is not particularly good.

I do think there is a profound risk of regulatory capture by very large institutions if you collapse regulatory oversight into one single entity. I think having multiple voices is beautiful. We testified before this Committee on the Advanced Approaches under Basel II. We resisted that, and we slowed it down. And because of that, our banks—commercial banks, FDIC-insured banks—had not transitioned into that new system, which would have significantly

lowered the amount of capital they would have had going into this crisis, unlike what happened in Europe and with investment banks.

So we think having multiple voices can actually strengthen regulation and guard against regulatory capture. If you have a single monopoly regulator, there is not going to be another regulator out there saying, "We are going to have a higher standard," "We are going to be stronger," or "We are going to question that." I think you lose that with a single regulator. So you should look carefully at the European models and how they functioned during the crisis.

Chairman DODD. We are talking here—John, let me ask you, we are talking about a consumer financial product safety agency. Obviously, the Fed is very much here. We are talking about that as well and having a prudential regulator. Why is that not necessarily the kind of checks and balances we are talking about in the system?

Mr. DUGAN. I cannot really defend the current system of so many regulators. As one of my predecessors used to say, it does not work in theory, but we have worked hard to make it work in practice.

And having said that, I think there is more you could do if you were so inclined, and you have gone from four regulators to three prudential regulators in the proposal. You could go the next step to have a single regulator for State-chartered institutions, which would bring you down to two. You could go to one regulator for the banks, and you could even bring in the holding company regulation to the prudential supervisor.

As I mentioned in my testimony, there are advantages and disadvantages in each of those steps. I think at the end of the day, if you put everything all in one place, it would be probably too much. And so I think that is probably a bridge too far, but there are things that you could do that would simplify things for the future.

I do not believe, and agree with Sheila, that this was a principal contributing cause of this crisis. But I think going forward we do have to think hard about what is the best system for the future, and giving those matters real thought is a good thing.

Chairman DODD. Dan and John, some quick responses to my question.

Mr. TARULLO. Mr. Chairman, among the many reasons why Members of this Committee will not be unhappy to see the summer recess come is they will not have to listen to me say, for about the third hearing in a row, that each proposal that comes before us is going to have some advantages and some disadvantages.

I do think, as John and Sheila have suggested, that nobody would sit down and write the system we have now if they were starting from scratch. But the system having been in place, you have seen that there are some advantages to splitting bank supervision. I personally think it would be a very bad idea not to have the deposit insurer have a bank examination function, so that the deposit insurer understands how banks are functioning before they fail, and thus be better able to resolve them.

I also think that it is important for the Federal Reserve, as the central bank and as the holding company supervisor, to have a window into how banks function.

Would there be efficiency gains in some sense from having a single regulator? There probably would be, but I think my colleagues to my right have already pointed out some of the disadvantages as well.

Chairman DODD. John.

Mr. BOWMAN. I would agree with some of the disadvantages that have been pointed out. I think the other question that we would have is the form that the current system holds, a multiple of regulators, really the cause of the issue we are dealing with today? And I would suggest that, in fact, the principal cause, as the Administration says in its proposal—high-cost loans, only 6 percent of the high-cost loans provided American consumers were provided by depository institutions that were regulated under the current system; 94 percent were provided by the so-called “shadow banking regulator.”

That is why we would suggest the focus really should be on filling the regulatory gaps that exist today and that really need to be filled.

Chairman DODD. Senator Shelby.

Senator SHELBY. Mr. Chairman, just for the record, just my observation, I would think that if you look at the record here of the failure of the regulatory bodies, that all roads seem to lead to the Federal Reserve. They don't lead to the FDIC. They don't lead to the Comptroller. They don't lead to the Community Bank Supervisor. But just about all of them lead to the Fed, and let us be honest about it.

I want to get into something else. Chairman Bernanke has testified before this Committee that this crisis has revealed that our Nation's “too-big-to-fail” problem is much worse than many thought. After the bailouts of Bear Stearns, AIG, Chrysler, and GM, our markets now have good reason to expect that the Federal Government will bail out any prominent company that gets into financial trouble, perhaps.

My question to you is, what steps need to be taken to restore market discipline and minimize the moral hazard created by the bailouts over the past year? Is this a problem that will not be solved until the Federal Government actually allows several prominent institutions to fail? In other words, we are going down a road, a dead-end road on the “too-big-to-fail” thing.

Sheila.

Ms. BAIR. Well, we very much agree with you, Senator, and that is why when I have testified before this Committee previously our priority focus has been on resolution authority. We need a mechanism that can resolve very large financial organizations in a way that is orderly, that protects the rest from any systemic implications, but makes sure that their creditors and shareholders take losses. We don't have that right now and I don't think we are going to get that restored market discipline until Congress puts something like that in place.

Senator SHELBY. John.

Mr. DUGAN. I agree that we need a better mechanism to have more orderly resolutions of companies that get into trouble so that you can have more instances where you don't have threats to the system just by resolving them. I think you need to do more up front

by way of capital requirements and liquidity requirements so they don't get into that position. And I think you will have more circumstances where larger institutions can be failed in an orderly manner.

I do think, however, that you have to preserve some flexibility for the Government—

Senator SHELBY. Sure.

Mr. DUGAN. —in emergency circumstances where the entire system is threatened, like we were last fall, to be able to address that concern, and I know that is hard, but I think you really need to do that.

Senator SHELBY. Governor.

Mr. TARULLO. Senator, I certainly agree with the utility of the resolution mechanism, but when you ask about market discipline, I think there is more that we need to do. The resolution mechanism comes at the end of the day. It comes at the time of failure. It would be better to create additional incentives that preclude the failure. We surely need more transparency and disclosure by financial institutions, particularly the largest.

And as I have indicated a couple of times in prepared testimony, I think we also need to be looking at alternative requirements for the capital structure of at least large institutions. There are a number of ideas out there that would require certain kinds of convertible debt to be in the capital structure of a company. That is good because there is market discipline as long as it is a debt instrument. The debt holders want to be paid. And they know if the financial institution gets into trouble, that that debt will be converted into equity. It will provide a buffer against loss and they will be subject to loss.

So I think that market discipline has a number of different avenues that we should pursue, and market discipline itself should be pursued alongside of some other regulatory mechanisms.

Senator, if I could, you know I was not at the Federal Reserve up until a few months ago, and as I have said repeatedly, I really do believe here is plenty of blame to go around everywhere. But I don't honestly think that all roads lead to the Fed on this. I mean, Bear Stearns—

Senator SHELBY. Well, which don't lead to them?

[Laughter.]

Mr. TARULLO. I would say, Senator, Bear Stearns, AIG, Lehman, Fannie and Freddie. There were a lot of problems in this system, and as I said earlier, I think before this crisis is over, we are going to have seen a lot of failures in a lot of kinds of institutions. I don't say that to try to deflect any responsibility. In fact, I think part of what I was trying to say in my prepared remarks and in the introductory remarks was that I and everybody on the Board takes seriously where things didn't get regulated as well as they should have and where the structure needs work, and that is why we started to make the changes we are already making.

Senator SHELBY. Just for the record, and we all know this, but who is the regulator, the primary regulator of the holding companies, the big banks that got into trouble? You know it is your Federal Reserve, and you are now—you weren't, but you are now a member of the Board of Governors. Let us be honest about it.

Mr. TARULLO. Well, that is absolutely true, Senator. In some cases, the bank is regulated by other regulatory agencies and there are also entities——

Senator SHELBY. But the primary regulator of the——

Mr. TARULLO. Of the holding companies, right.

Senator SHELBY. ——is the Federal Reserve.

I haven't got much time, but I want to pick up on a couple of things. Today's *Wall Street Journal* had a tough article dealing with Secretary Geithner when he met with a bunch of you, where he told the financial regulators that they should stop—can you imagine the gall here of the Secretary—that they should stop criticizing the Obama administration regulatory reform plan. My gosh. I hope you won't quit. I think your honesty and your candor here is very important.

We recognize the role of the Treasury to set some policy for financial regulation. But ultimately, it is going to be the Congress up here. This Committee, both sides of the aisle, and the House is going to set the tone and create the laws. And I appreciate you bringing this independent perspective with all kinds of pressure placed on you.

Does the testimony that you have given here today, that you have provided, is that your own views, such as it was, not in any way influenced by Secretary Geithner's tirade against you the other day? It is a serious question. Is this your——

Chairman DODD. Who are you asking the question of here? Which one of these——

Senator SHELBY. I was asking all of them.

Mr. DUGAN. Yes, it is our own testimony. Congress requires and prohibits the Treasury Department from intervening in any legislative view we express to the Committee. We do not clear our statements through the Treasury Department and we take that independent function very, very seriously.

Senator SHELBY. Sheila.

Ms. BAIR. Yes. I don't think anybody thinks we are not independent. It was absolutely our testimony.

Senator SHELBY. We hope you are going to stay independent.

Ms. BAIR. I will.

Senator SHELBY. Governor.

Mr. TARULLO. Absolutely, Senator. The only people I discussed this with are my fellow members of the Board and the staff of the Federal Reserve.

Senator SHELBY. Mr. Bowman.

Mr. BOWMAN. Senator Shelby, I think our testimony speaks for itself and we do take exception to the Administration's approval, and yes, we are independent.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Senator Brown.

Senator BROWN. Thank you. I was a little surprised by Senator Shelby's question, considering the positions that you have all taken.

Let me look at this in kind of a different way. The public has a general understanding. The investing public and the victims of this financial disaster, which is my whole State and most of this coun-

try, has a general understanding that regulation of financial institutions, putting it mildly, fell far short. Some have the belief that the most, I think the most egregious institutions found an agency that was too easy on them. In Washington, we call that regulator shopping. They just think that the Government, for whatever reason, was too easy on Wall Street greed.

And I hear each of you. There may be some turf issues, and that may be a cynical way to look at it and I apologize if that is the way you take it, but I hear the—I see the President’s plan, the President’s proposed bank supervision framework. I hear each of you disputing major parts of it. How would you explain to the American public what the next step is? How do we fill the financial gaps in our financial regulatory system if consolidation of regulators is not the best move? How do you explain to the public why four very smart people playing very important roles in our financial institution regulatory system and an Administration that, I think, has equally smart people that understand this, why is there not more agreement?

How do you explain in understandable terms, if you were talking directly to the American people now, not to this Committee, what we should do to fill these gaps so these kinds of egregious, awful things don’t happen again? I will start with you, Ms. Bair.

Ms. BAIR. Well, I think there was arbitrage, but it was between the bank and the nonbank sectors. It was excess leverage with investment banks and hedge funds and other types of vehicles *versus* the higher leverage in risk-based capital requirements that we had for commercial banks.

On consumer protection, it was third-party mortgage originators that were not affiliated with insured depository institutions originating loans being funded by Wall Street funding vehicles. The third-party mortgage originators were pretty much outside of any type of prudential or consumer protection standards that were within the purview of the banking regulators.

So I think it is unfortunate the word “bank” is used for just about every institution, but in my world, a bank is an FDIC-insured institution. While we all made mistakes, the insured depository institution sector has held up pretty well. This is why you saw in December so many financial companies fleeing to become bank holding companies and trying to grow their insured institutions, because that was the sector that was left standing, which is hard for the FDIC because our exposure has increased significantly. We have tried to do the things we need to do to stabilize the system. But, this has increased our exposure significantly.

As I have testified before, the arbitrage is between the banks and the nonbanks. Having a consumer agency with a focus especially on examination and enforcement of the nonbank sector and having a Systemic Risk Council that would have the authority to define systemic issues or systemic institutions, whether or not they voluntarily want to come in under the more stringent regulatory regime we have for banks and bank holding companies.

The arbitrage was between the bank and the nonbank sectors. It was not among different types of bank charters, and certainly not between the choice of a State or Federal charter. There are 8,000 community banks in this country. Most of them have a State char-

ter, so consequently, we regulate about 5,000 banks. I don't think they contributed to this, but you have seen traditional resistance among community banks to regulatory consolidation for fear, frankly, which I share, that inevitably there would be a regulatory viewpoint that would be dominated by the larger institutions if everyone was lumped in together.

There is a valid reason for State charters. The community banks and State-chartered community banks tend to be more local in their interest and how they conduct their lending. To try to draw that issue into the much larger problems we had with arbitrage between banks and nonbanks and then the lack of regulation of derivatives, I think, is misguided and is not where you should be focusing your efforts or the American public should be focusing its efforts.

Senator BROWN. Mr. Dugan, your thoughts?

Mr. DUGAN. I agree with everything Sheila just said. I would point out that we also regulate about a quarter of the Nation's community banks, so we do all different sizes of institutions. And most of the problems did not take place inside of the insured depository institutions that we supervise, which are the most extensively regulated parts of the system.

Of course, we did make some mistakes and there were some problems. I am not discounting that. But that is not where most of them were.

The second thing I would say is I think there are a number of very sound and strong proposals in the Administration's reform proposal, which I do support, as I testified. There are just some places where we think it should be shaped differently, and carrying out our duty to provide our views independently, that is what we are trying to suggest.

With the CFPA, for example, we agree that a strong Federal consumer protection rulewriter to provide a single set of rules that applies to everybody is a very powerful change. But we think taking that same step and applying it to the enforcement and examination of the depository institutions should stay with the bank regulators where it works well, and instead, all of that effort should go to the examination, enforcement, and implementation of the nonbanking sector where there were very substantial problems that have led to disproportionately higher levels of foreclosures, for example, in your State and many of the States represented in this room.

Senator BROWN. Thank you.

Governor Tarullo.

Mr. TARULLO. Thank you, Senator. If you are asking, what should the public be focused on, my suggestion would be too big to fail. That is not the only problem by a long shot, but to me, it continues to be the central problem—the ability to avoid the moral hazard that comes with “too-big-to-fail” institutions. As I said a moment ago, I think we need a variety of supervisory and regulatory tools to contain that problem, whether it is resolution, bringing systemically important institutions into the perimeter of regulation, making sure that the kinds of capital and liquidity requirements that systemically important institutions have will truly contain untoward risk taking.

I think we are going to need a broad set of activities. "Too big to fail" was not the only cause, but it was at the center of this crisis and that is, I think, what we all need to focus on.

The only other thing I would say harks back to a colloquy you and I had a couple of weeks ago when I was testifying. You and I were talking about attitudes and orientation and how people in the Congress and the regulatory agencies and the Administration think about issues and problems. It is not easy to ensure against people losing interest in issues. But I think that is a role that, in a system of Government that has a lot of checks and balances, we have to think about.

How do we try to institutionalize skepticism and critical thinking, to look at developments in the financial world so that we don't just say, well, that is just another market development; it must be benign. But instead, we must begin to distinguish intelligently between benign, useful innovations on the one hand and building problems on the other.

Senator BROWN. Thank you.

Mr. Bowman.

Mr. BOWMAN. Thank you, sir. One of the advantages of being last on a panel like this is you usually get to agree and sort of dispel the notion that we disagree on so many things. I agree with what my colleagues have said, but I would also like to focus on the arbitrage position between banks and nonbanks.

I think the CFPB provision of the Administration's bill goes a long ways toward dealing with that situation. The difference is that you don't get to sell a product at a nonregulated entity under different terms and conditions, a different regulatory structure, than you would if you were doing so in a depository institution or otherwise regulated entity. I think that is one of the critical components of this Administration's proposal to fix that gap.

Senator BROWN. Thank you. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Brown.

Senator CORKER.

Senator CORKER. Mr. Chairman, thank you, and as always, I thank each of you for your testimony.

I also, like I am sure most people did, read the story this morning in the *Wall Street Journal* regarding the meeting on Friday, and generally speaking, did it capture the essence of the attitude in the meeting?

Ms. BAIR. Who is going to take that one?

[Laughter.]

Senator CORKER. Very briefly. I just want to move on to other—

Mr. DUGAN. Senator, it was a candid conversation about our agencies' different views on the different subjects and—

Senator CORKER. It was a generally fair article?

Mr. DUGAN. A lot of it was true.

Senator CORKER. OK. So here is—

[Laughter.]

Senator CORKER. I guess what I would like to get at, it is my understanding that the original draft had the National Banking Supervisor not being actually a part of Treasury. I think we have seen today that—and we have known for some time—Treasury can

exercise—try to exercise influence over the organizations, and my understanding is that, again, in the beginning, the National Banking Supervisor was not a part of Treasury and at the last minute it was put back in.

And I just wonder if one of the things we ought to be looking at is absolutely ensuring that this Banking Supervisor is not a part of Treasury and even more independent than has been laid out, very briefly.

Mr. DUGAN. May I respond to that?

Senator CORKER. Yes.

Mr. DUGAN. This may surprise you, but I was a strong advocate of keeping it within the Treasury but subject to the same firewalls that we have now, which does give the agency a very strong ability to operate independently. I believe that making it independent and creating a new board, if you have three other regulators still in existence and everybody has got boards, I think it will confuse things. It is critical, however, that you do have those statutory firewalls that were put in place. And that was a position that I advocated.

Senator CORKER. Any differing opinions from the panel?

Ms. BAIR. As an independent agency that does the types of supervisory functions that the OCC and OTS perform, we look to them to help protect the Deposit Insurance Fund through their front line prudential supervision of banks that we insure. So, I think there are some merits in making it independent. As an independent agency, you do want to make sure it is as insulated as possible from any type of influences that might not be focused on prudential supervision and the safety and soundness of the institution.

Senator CORKER. OK. Thank you.

Mr. Tarullo, I think I have actually been very supportive of our Chairman of the Federal Reserve, differing from some of the folks on the panel. And yet at the same time, there is no doubt the Federal Reserve had some failings in this last go around.

I read your 2005, the Federal Reserve Service Purposes and Function document, and it actually does, just for what it is worth, state that one of your responsibilities is maintain the stability of the financial system and containing systemic risk that may arise in financial markets and providing financial services to depository institutions. So I think it is fair to say that, in essence, you sort of did have responsibility there.

I am wondering how harboring all of that at the Federal Reserve would alter, if you will, behavior. I think all of us understand today that we need to be more concerned about systemic risk. I am sure the Fed does, too. And again, I say this with respect for the organization, but obviously with concerns. I am just wondering what would be different if, in fact, the Fed was the systemic regulator—the systemic regulator.

Mr. TARULLO. Senator, I don't think there are any proposals on the table that would really make the Fed a systemic risk regulator in the sense of being able to swoop in anywhere, anytime, and say, we want to do something about this. The proposal that we have endorsed is making the Federal Reserve the consolidated supervisor of systemically important institutions.

I would say in direct response to your question, there is certainly a responsibility there, and I would be the first to say that respon-

sibilities of all the financial regulators, including the Fed, were not exercised as effectively as they ought to have been. But I would also say that when you give an entity responsibility, you do have to make sure that you give it authority to achieve that responsibility, to fulfill it, and that you have the mechanisms that will allow it to do the job.

And when you have a circumstance in which large institutions that turned out to be systemically important—I think in some cases to the surprise of many—and were not within the perimeter of regulation, it was obviously not going to be an easy matter to contain the activities of those institutions, including a lot of the wholesale funding and a lot of the very tightly wound, complex securitization that was a major contributor to these problems.

So I would say, first, you need to make sure that the appropriate legal authorities are present. Second, as I have often said, there needs to be a reorientation of our regulatory approach more generally toward systemic risk. And third, the Federal Reserve, I think, needs to take more advantage of the comparative abilities that it has. That is why we wanted to move forward, to make use of the economic and financial expertise to provide a monitoring of and a check upon the on-the-ground supervisors. That is where the advantages lie and that is where we ought to bring them together.

Senator CORKER. Let me just ask one last question. I know there are differing thoughts on “too big to fail,” but each of you feel that that is a big issue, how to deal with that. I know that I would like to see a resolution mechanism in place where they resolve much like Chairman Bair proposes.

Mr. DUGAN. I don’t understand how, if you continue to give Treasury the ability to solve the problem with taxpayer money if they deem it an important thing to do, I don’t understand how that creates any market discipline. It seems to me that leaving that vague line in place defeats all market discipline. I don’t understand how you can cause those to measure up or how we could craft something that actually worked and caused people like the Senator from Ohio’s constituents and mine, which I think are different in thinking about some things, but I think they would agree that that is wrong, and yet you propose keeping it in place and I don’t understand that.

Mr. DUGAN. I think there are ways that you have to limit it. I think there are presumptions so that you make it more difficult to exercise. I think there are measures that you have to take up front so you don’t get yourself in that position.

My only point, though, is this: when you are in a crisis and you need to take action and you need to do it to protect the financial stability of the system, I don’t think we should tie the hands of the Government from being able to do it in a moment’s notice if we have to. I don’t ever want to be in some of the weekend situations that I was in last fall, and we did have mechanisms that ensured a wide variety of the Government was involved in the decisions. People can second-guess some of those judgments, but I really do not think it is a good idea to completely forbid the ability to address systemic situations and crises if we have to.

Senator CORKER. Thank you.

Chairman DODD. Thank you very much.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you all for your testimony.

I gather from the panel that, in fact, there is a sense that beyond maybe what the Administration is proposing, which is merging OTS into the OCC, there isn't a view that there should be any further regulatory consolidation. So my question is, if we don't do that, then there still seems to be the opportunity for regulatory arbitrage where the regulated companies would choose what they believe to be the most lax regulator.

So what mechanisms can we put in place to prevent that, to prevent the shopping? For example, the Administration's restrictions that are proposed on the ability of a troubled bank to switch charters, is that enough by themselves to prevent a regulatory arbitrage that we want? I would like to hear some of your ideas on that.

Mr. TARULLO. Senator, I will start if that is OK. Congress has provided some mechanisms to contain regulatory arbitrage. A lot of restrictions that apply to national banks are made by Congress to apply to State banks if they are going to get Federal deposit insurance. That is an important backdrop, number one.

Number two, the provision you just referred to, I think is an important one, and it is one on which the agencies have already tried to act. Actually I was going to tell the Chairman this—we had a break in your hearing in March during which Chairman Bair turned to me and said, you know, we have to figure out a way to do something about entities trying to get different charters when they are under enforcement actions or they see an enforcement action coming. And so she launched an initiative among the agencies to have us all reaffirm that charter conversion ought not to happen unless the institution is sound, there are no enforcement actions pending, and it is not being used to avoid supervisory ratings.

A couple of the institutions shifting charters over the last several years that have become reasonably well known engaged in that sort of flight from enforcement. So I think this was a very important gap to plug.

Senator MENENDEZ. Anything else? Is that enough?

Mr. DUGAN. I think it is very important. We have seen over the years, a number of situations in which people have switched charters to avoid supervisory action. I totally support the action we have taken. If we wanted to go further and put some of that in legislative language, I would think that might be a very good idea, just to make sure that we don't change it in the future.

Senator MENENDEZ. Chairman Bair.

Ms. BAIR. I would agree with that, and we indicate that in our written testimony. We are the insurer. We are not the chartering entity. So, once deposit insurance is granted, if the entity then decides later to shift charters, we really don't have a role in that decision. We particularly feel that it is in our interest to ensure good, strong, robust prudential supervision. We do not want charter conversions to, in any way, be used to undermine that process.

We would also be happy to work with you. Senator Reed and I had a conversation a while back about putting something like that in the statute to make sure the provision is there.

Senator MENENDEZ. Well, I would join Senator Reed in that effort.

Let me ask you, some big banks——

Mr. BOWMAN. Senator Menendez, if I could address that question——

Senator MENENDEZ. Surely.

Mr. BOWMAN. ——I think one of the charters, which I think is being used as an example of an arbitrage opportunity was the choice by Countrywide to move from regulation by the OCC and the Fed to regulation by the OTS. This was in March of 2007. In doing so, Countrywide brought approximately \$92 billion in assets to the OTS. We undertook a very extensive coordination with the Fed, including the Fed Bank of San Francisco, the OCC, and others, as well as State regulators of various affiliates within the Fed's holding company jurisdiction. We granted the charter to Countrywide.

But one of the facts that seemed to be sort of lost in a lot of the discussion is that 3 months or 4 months before Countrywide came to the OTS, Citibank took two historic thrift charters totaling approximately \$232 billion in assets to the national bank charter from the Federal thrift charter shortly after Countrywide came. Cap One took approximately \$17 billion in assets from a thrift charter to the OCC.

I would suggest that the mere action of an entity, a business entity choosing to change its charter based upon its business plan in and of itself does not necessarily suggest that they fleeing a particular set of regulatory structures or whatever else.

Senator MENENDEZ. No, I appreciate that.

Mr. BOWMAN. I just wanted to make myself clear on that point.

Senator MENENDEZ. I appreciate that.

Let me ask the question, several big banks have come here and argued before the Committee that we shouldn't have a Consumer Financial Protection Agency because it is bad to separate safety and soundness regulations from consumer protection regulations. But that argue doesn't, at least to make, make much sense because safety and soundness regulations and consumer protection regulations are currently together in the same agencies and that very system failed miserably to protect middle-class American consumers.

So if there is concern about regulators having overlapping responsibilities, can't that be solved by assigning clear responsibilities to each regulator and creating some solid procedures for resolving conflicts among regulators?

Ms. BAIR. On the consumer protection side, rulewriting traditionally has been divorced from enforcement, so the FDIC and the OCC have no power to write consumer rules. We examine and enforce, but we have never had rulewriting authority. That is separate already. So I think the bank regulators generally—I do not want to speak for others—are supportive of this because the arbitrage, the choice, if you will, was not so much among bank charters, but between being a bank or being a nonbank. Mortgage brokers with very little regulation could originate loans without anybody looking over their shoulders, regarding undocumented income, or regressively marketing teaser-rate 2/28s and 3/27s.

The value added with this new agency is providing rules across the board for both banks and nonbanks. And as we have all testified, keeping the examination and enforcement function with the bank regulators for the banks and having this new agency focus its examination and enforcement resources on the nonbank sector where there is not much oversight would give consumers protection across the board. So, whether they are dealing with a bank or a nonbank, they have some baseline level of protection and a regulator actually coming in and making sure those rules are being enforced and adhered to.

Does that answer your question?

Senator MENENDEZ. Yes. Mr. Dugan, do you want to jump in?

Mr. DUGAN. I was just going to say I agree completely with everything Sheila just said, and attached to my testimony are examples of a number of the ways in which integrated safety and soundness and consumer protection supervision has found issues for both safety and soundness purposes and for consumer protection purposes that otherwise would not have been found under the current system. We believe that under the examination and supervision system currently in place, bank examiners are good at implementing rules that are written, and to the extent that a new agency writes strong rules, they will be complied with by banks through this function better than any other alternative model.

Senator MENENDEZ. So basically—and, Mr. Chairman, I will end on this. My understanding from the panel is that you are all in support of a consumer financial protection agency?

Mr. TARULLO. No, Senator, that is not true. The Federal Reserve has not taken a position one way or another on the creation of the—

Senator MENENDEZ. Are you going to take a position?

Mr. TARULLO. If we were specifically asked, I guess we would at least discuss among ourselves. I think our effort to this point has been to point out the virtues of integrated supervision and regulation of consumer products alongside the obvious virtues of a separate agency.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Menendez.

Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

I am very happy to see all of you here today. After you kissed the ring of the Secretary of the Treasury, you finally got out of the room, and you are here in person to testify, independently. It is really nice to see that.

Mr. Tarullo, I want to go back to something that you said earlier. You said that the Fed would like to have the authority and the power to enforce. We gave you that 14 years ago—more than 14 years ago, actually. Now it is 15 or 16 years ago. And you did not write a regulation for 14 years to govern the banks that were under your control or the mortgage brokers that were under your control. I know you were not at the Fed. That is not the problem. The problem is the Fed had the ability to act and did not.

So you might understand some of us not being agreeable to giving you more power when you failed in enforcing the power we gave you. So just for your information, you can take it back to

Chairman Bernanke and the rest of the board and say, "You know, it took you, Mr. Bernanke, 2 years after you became Chairman to write a regulation on mortgages. And it took Chairman Greenspan 12 years not to write it." So we are a little reluctant to give the Fed new additional authority. I just happen to agree with Chairman Bair on when the rubber hits the road, they are there to make something happen.

Now, our panel is trying to figure out how to stop the rubber hitting the road—in other words, how to prevent systemic risk from becoming too big to fail. That seems to be the major problem.

Senator Corker brought it up earlier today about, you know, we really need ideas, because we seem to have failed by not giving the authority to the right person or the right person not enforcing the authority we gave them.

So my question to you is: What additional authority do you think we should give the Fed?

Mr. TARULLO. Senator, as you know, I agree, personally—it is not a Board position—with you that the Fed took too long to use its existing authority to enact consumer protection associated with mortgages. I was referring a few moments ago—and I will elaborate on it now—to the authority to provide consolidated supervision for any systemically important institution.

As you know, a year-and-a-half ago, that statement would have, in practical terms, meant that a whole set of institutions—at that point, the five free-standing investment banks—would likely have been brought in by law to the consolidate supervision program.

Because of the financial crisis, and the fact that a couple of those institutions are no longer with us and others have become bank holding companies, the immediate practical importance of the authority would not be as great as it would have been a year-and-a-half or 2 years ago. However, there is first the possibility that an institution which has become a bank holding company in the middle of the crisis, in an effort to get the imprimatur of having consolidated supervision, would, when things calm down, decide it does not so much like being a supervised entity, so it would dis-
elect being a holding company.

Senator BUNNING. We could prevent that.

Mr. TARULLO. You could.

Senator BUNNING. Yes.

Mr. TARULLO. Absolutely. And, second, if in the future other institutions grow or activities migrate from the regulated sector to other institutions, we would want to make sure that any such institution which itself becomes systemically important would also be subject to consolidated supervision. That is what I referred to earlier.

Senator BUNNING. Sheila, could you expound on the ability of the FDIC to preempt, in other words, to get in front of the foreclosure or the shutting down of our—in other words, looking prior to, with your regulatory regime into banks that you have under the FDIC jurisdiction? In other words, preventing.

Ms. BAIR. I think Congress gave the FDIC helpful new tools—they were finalized in early 2006—to make risk-based adjustments to our premiums that we charge for deposit insurance, because at least for insured depository institutions, this helps us provide eco-

conomic disincentives to high-risk behavior. This is a tool we are using and will continue to further refine. But, it has been helpful, I think.

I think the big problem or the shortcoming that we have found is that when these larger entities get into trouble, so much of the activity is outside the insured depository institution that our traditional resolution mechanism does not work. We can only resolve what is in the FDIC-insured institution, which is why we believe it would be very helpful to us, at the FDIC collectively, to get ahead of this. First of all, it would be a strong disincentive. We need more regulation, clearly, of these very large institutions, but we also need greater market discipline and the certainty that investors and creditors will take losses if an institution gets in trouble and would have come to the Government for help. They will be put into a resolution regime.

Senator BUNNING. Let me ask you this simple question. If an entity is listed on an exchange, wouldn't the Securities and Exchange Commission have some kind of ability to examine all the aspects of that institution? I am looking at AIG, for instance.

Ms. BAIR. Well, generally it is the holding company.

Senator BUNNING. Correct. It is the holding company.

Ms. BAIR. It is the holding company, not the bank, that is listed. The SEC's regime is focused not on prudential supervision but on investor protection through a transparency regime. They do not do any kind of safety and soundness prudential oversight of listed companies. They are focused more on ensuring appropriate financial disclosure for the benefit of investors.

Senator BUNNING. Thank you.

Thank you, Mr. Chairman.

Chairman DODD. Thank you.

Senator TESTER.

Senator TESTER. Thank you, Mr. Chairman, and I thank the panelists for being here today. An interesting discussion. I think we all agree that the gaps exist. I think we all agree that we still have not sealed those gaps up. And so I guess referring to the testimony from a gentleman on the second panel, a former Comptroller of the Currency, Mr. Ludwig, he writes and, in fact, recommends to "streamline the current 'alphabet soup' of regulators by creating a single world-class financial institution-specific regulator at the Federal level while retaining the dual banking system," which is very, very close to what, quite honestly, I have in mind. And he goes on to lay out a system of critiques, and you guys have somewhat addressed this in some of your other questions.

But going back to what Senator Menendez asked in that he wanted to know if it could be laid out to seal these gaps by rule-making or some other method, I am not sure I got an answer to that question.

So I want you to share your thoughts as concisely as possible, because each one of you could burn 4 minutes and 50 seconds with one answer if you wanted.

As to why significant reform in this direction is not the direction to go, taking off your hat as your individual department leaders—because I know turf does play a role. If somebody said, "I am going to dissolve your farm," I would be a little upset with it. But just

tell me how we can get these gaps closed without doing something like this and why this would not be a good idea.

Go ahead, Sheila. We will just go down the line.

Ms. BAIR. Again, I think the issue was not about the choice among bank charters. It was between being a bank or not being a bank and being much less regulated in the nonbanking sphere. I think that is the arbitrage that needs to be addressed.

Senator TESTER. And what you are saying is that could not be addressed with one——

Ms. BAIR. No, it would not, because you would just be consolidating what we all do for insured depository institutions. That would not expand beyond the already heavily regulated sector.

Senator TESTER. Could it?

Ms. BAIR. I think with a systemic risk council it could, at least for risks that are systemic in nature. You would be able to give this new systemic risk council—which would also include the SEC and the CFTC—some ability to look across systems and to impose prudential requirements regarding capital and leverage where needed to mitigate systemic risk. And, yes, that would be across all sectors, not just for banks.

Mr. DUGAN. Senator, I believe you could do more streamlining. You could move more in the direction you are talking about. We do not have an ideal system. But as my testimony suggests, there are some issues you are going to have to confront if you want to have an effective Federal Deposit Insurance Corporation. If you go for long periods without having any bank failures, they are not going to have a lot to do and will not know the system very well if they do not supervise banks.

Likewise, the Federal Reserve has some things to offer to supervision, particularly of the very largest institutions at the holding company level that are engaged in a lot of nonbanking activities. And to think that a banking supervisor would do all of that as well without having the benefit of direct supervision raises some questions.

Senator TESTER. OK.

Mr. TARULLO. Senator, I would say, trying to be succinct, the two most important gaps to fill are: first, making sure that every systemically important institution does come within the perimeter of regulation; and, second, what we were discussing earlier, which is to say the assurance that there cannot be charter conversions motivated by efforts to escape enforcement and escape bad ratings. And just to be clear, I think it would be a perfectly good idea for the Congress to legislate on that matter so that in the unlikely event that our successors did not share the same view, they could not go in the opposite direction in which charter conversions could be done for the wrong reasons.

Senator TESTER. I understand that, but what you are saying, then, a world-class financial institution, a specific regulator could work.

Mr. TARULLO. Well, I actually think, as Sheila suggested early in the hearing, that what we have learned in this crisis is that there were lots of different models of supervision and regulation around the world, and none of them performed particularly well. And that seemed to me more of a lesson than anything about a particular

structure or anything else. None of them performed particularly well.

Senator TESTER. OK. Go ahead.

Mr. BOWMAN. And I would also pick up on the point, your concept is a world-class financial institution regulator. I think one of the lessons that we have learned—and Sheila has mentioned it a couple times—is that we have banks and nonbanks who are providing the same kinds of services in a different structure. If you are a financial institution, you do have world-class regulators currently. If you do not, you operate in a less than regulated or under-regulated environment.

One of the suggestions I would have is that if you wanted to close that gap, there is a process by which you can do that. It starts with the CFPB, the Administration's proposal. The difficulty is how they carry out, how they enforce the regulations. The Administration proposes to use the CFPB as that. We suggest as bank regulators we can do it more effectively. But that is the start, because then you have to start looking at things like capital requirements, capital structure for those who are not financial institutions.

Senator TESTER. OK. Currently, have we made any progress, and not necessarily—well, I think “we” as a general group as well—towards regulation of derivatives, credit default swaps, those kinds of things? Or are we in the same boat we were in a year ago? Same boat, Mr. Bowman?

Mr. BOWMAN. Yes. I would say that we are.

Senator TESTER. OK. Everybody agree with that?

Ms. BAIR. Yes, and that does require legislation to fix.

Senator TESTER. Yes. OK. Are we concerned about that?

Ms. BAIR. I am. Yes, I think it is huge.

Mr. DUGAN. I think it is very important.

Senator TESTER. Mr. Chairman, have you gotten any recommendations from any of these folks or anybody else on how we should be regulating derivatives and credit default swaps?

Chairman DODD. What we are trying to do here is fashion, obviously, a piece of legislation that comprehensively deals with all of this, and the hope is we are going to do that when we get back in the fall. That is the purpose of these hearings, to bring these ideas together.

Senator TESTER. But has anybody given you any concrete ideas or—

Chairman DODD. Oh, there have been all sorts of suggestions made on how to do it, clearinghouses and so forth. We have got a lot of recommendations.

Senator TESTER. Well, I just think it is—as we move forward here, I can just real quickly—

Chairman DODD. In fact, I would just say, John—and I will leave you more time—Senator Reed and Senator Bunning, in fact, are working on an idea that—in fact, a number of our colleagues here are working on various ideas to be part of the larger bill. The Subcommittee is working on it.

Senator TESTER. I think it is good. It is somewhat distressing that, quite frankly, from my perspective—and I am not an expert in this field at all—we have a lot of people who are trying to do good work; but there are still gaps, and obvious gaps. And then at

the banking level, we have got a myriad of regulators out there. Quite frankly, if I was a banker, I would be going crazy. I would. I would not know—I really would not know which person to be—knowing who I have to deal with, let us just put it that way, because we are coming at it from a lot of different angles.

Then, you know, if you take into consideration—I think, Sheila, you said this. Community banks were not really a problem here, but yet they are getting pressed just as hard as anybody, from my perspective, as far as regulation goes. And I just think that this is an opportune time in the middle of a potential—not a potential—in the middle of a crisis to really take a lot at our regulation system and say let us simplify it, let us make it lean and mean and simplified. And I do not think that can happen unless we are willing to think outside the box and do things differently than we have done in the past.

Thank you all for being here.

Chairman DODD. Thank you very much.

Senator VITTER.

Senator VITTER. Thank you, Mr. Chairman.

Ms. BAIR, I wanted to ask you a few things that are little bit off topic but that are important, and that has to do with the recent actions of the Financial Accounting Standards Board with regard to bringing certain things that have been off balance sheet, on balance sheet, and what impacts that will have on institutions.

How will FDIC treat the consolidation of previously off-balance-sheet entities? And, in particular, will the agency require additional capital for assets that are brought on balance sheet?

Ms. BAIR. Well, yes, banks must follow U.S. GAAP. So if those are the accounting rules, if more assets are coming on balance sheet, capital levels are going to be impacted accordingly.

Though we still have some concerns about the timing of all this, we support the general direction of bringing assets back on balance sheet. But the timing still gives me some heartburn—whether they really need to be on this accelerated framework.

I think it also could be very damaging to efforts to get the securitization market back, because the way the rules are written now, as I understand, even if you just retain some portion of interest, the whole securitization might have to come back on balance sheet. That also goes at cross-purposes with our efforts to try to get originators to have some skin in the game.

There are a lot of issues and questions we have about the timing, but we cannot control that. FASB is not an entity that we have any control over. We can file comment letters and that is about it. But banks must follow U.S. GAAP.

Senator VITTER. So are the capital ratios set in law, or are they—

Ms. BAIR. Well, yes. Prompt Corrective Action capital levels are set by statute, yes. There is not a lot of flexibility there.

Senator VITTER. And so there is no flexibility for any phase-in period?

Ms. BAIR. Not very much at all, no.

Mr. DUGAN. Senator, traditionally the leverage ratio follows GAAP completely. The risk-based ratio has some variations, and at times has been more restrictive than GAAP. There also is some

flexibility to look at this and phase it in over some time. This is an issue all the regulators are looking at now to try to address some of the issues that Chairman Bair just raised.

The bottom line is this stuff is coming back on the balance sheet. Banks are going to have to hold capital against it. It is really a matter of timing and how it gets phased in.

Senator VITTER. Well, I do not think anybody is arguing about the fundamental issue, but I am concerned with timing and phase-in because it could have negative consequences if it were, you know, here tomorrow overnight. So what is the current thinking about how that should be handled?

Mr. DUGAN. I think the regulators are still discussing how this affects regulatory capital. The accounting rules become effective at the end of this year, beginning of next year, and how the regulatory capital rules respond is something that we will be discussing and providing some notice to the public shortly.

Senator VITTER. When do you think there will be fairly clear guidance for institutions about what to expect and what timetable and what phase-in, if you will?

Mr. DUGAN. If I had to guess—and this is an interagency process—I would say weeks, not months.

Senator VITTER. And I assume all of the agencies and regulators involved are in discussions about this?

Mr. DUGAN. It is an interagency rule, as capital requirements like this always are. So there will be a discussion among the agencies.

Senator VITTER. OK. Does anyone else have any comments about that?

[No response.]

Senator VITTER. OK. Thank you. That is all I have, Mr. Chairman. Thank you.

Chairman DODD. Thank you very much, Senator.

Senator Reed.

Senator REED. Thank you, Mr. Chairman.

Since Countrywide, was brought up, I just want to make sure I have got some facts right. It started off with a national bank subsidiary. You regulated the bank, Mr. Dugan, and the Fed regulated the holding company?

Mr. DUGAN. That is correct.

Senator REED. And under your policy and case law, a subsidiary mortgage company, an affiliate mortgage company was not subject to California law.

Mr. DUGAN. We regulated the bank, and it did a portion of its business inside the bank. It did most of its subprime lending outside the bank, not in the bank. The affiliate was subject to California law.

Senator REED. It was subject to California law.

Mr. DUGAN. Yes, but the bank itself was subject to the uniform Federal standards of the National Bank Act, and was not subject to California law. They did not do their subprime lending that caused a number of problems in the bank.

Senator REED. Just to be clear, the subprime lending was in an entity that was subject to California law.

Mr. DUGAN. Correct.

Senator REED. Attorney General review, everyone else like that.

Mr. DUGAN. Correct.

Senator REED. The Fed would have responsibility to review or inspect that mortgage company as an affiliate.

Mr. DUGAN. At that time, before they switched charters, yes.

Senator REED. Right. And did they do that, to your knowledge? Or what template did they use?

Mr. DUGAN. You would have to ask the Federal Reserve. I will say, as in my testimony, that philosophically, historically, there has been this anomaly where the bank in a holding company gets very heavily inspected and regulated and is subject to the most intensive regulation, but the holding company affiliates were not subject to the same requirements for annual inspections. And that needs to be fixed, and the Federal Reserve has recently been doing more in that area, but it is not the same, and I believe it should be the same.

Senator REED. Let me switch to Mr. Bowman. When Countrywide came into your supervision, you were the holding company's supervisor, and you were also the bank's—the FSB, I presume.

Mr. BOWMAN. Correct.

Senator REED. And the company that did the bulk of the subprime was a California-regulated mortgage entity.

Mr. BOWMAN. There were a number of State-related affiliates within the holding company structure. I do not remember how many or how many States. I do not remember the percentage of California State *versus* New York *versus* other States.

Senator REED. When you reviewed, your organization reviewed and inspected these holding companies, did you notice anything—did you inspect them or did you just inspect the FSB?

Mr. BOWMAN. We actually did a number of things. We spent a lot of time with both the Fed and the OCC, as I mentioned earlier, in previewing sort of what it was that was coming our way.

We also convened shortly after granting the charter. Again, the charter was granted March of 2007. We convened what I would call a “regulators conference,” where we invited and, in fact, had regulators from many, many States—I do not remember the exact number—come in and discuss with us some of their particular concerns, if any, related to the operation of the affiliates within the holding company structure, including New York, California, and others.

Senator REED. And did that alert you to any potential problems?

Mr. BOWMAN. Yes, it started to. Yes, it did, sir.

Senator REED. OK. Thank you.

Let me switch gears. We had a few hearings ago Mr. Meltzer and Dr. Rivlin, who have a long-time association with the Federal Reserve. And their suggestion was that the Federal Reserve essentially get out of the business of supervising and regulating entities and concentrate on the issue of the monetary policy and perhaps, you know, other issues.

My question is—and I will let you answer last, Governor. I think you have an opinion about this. But to the other panelists, if the Federal Reserve following this advice by two very knowledgeable people and experienced people, does not perform the role as the supervisor for large holding companies, who would or should? Do we

have to create another entity? What is your general comment about that? Then I will conclude with the Governor.

Ms. BAIR. The Federal Reserve is the holding company supervisor for the vast majority, but not all of the very largest institutions. So, yes, I think you would have to create a new agency to do it if the Federal Reserve was not doing it.

Senator REED. Mr. Dugan, do you have a comment?

Mr. DUGAN. I think you could put the holding company supervisor and the bank supervisor in the same entity. That is how the OTS works. You could do it. And I think, frankly, for smaller institutions and a lot of institutions where the only subsidiary of the company is the bank, there is some logic to that. But where you have companies, as was talked about earlier, where a lot of different businesses were engaged in nonbanking kinds of activities, that is where the particular expertise of the Fed—because of its closeness to the capital markets, its open market operations, its international central banking, all of that comes into play. Replicating that would be the most difficult challenge for any agency that tried to re-create it, either separately or inside a prudential supervisor.

Senator REED. Mr. Bowman—and quickly, because I have to give the Governor some—

Mr. BOWMAN. Yes, I would agree with that. We currently regulate both the holding company underlying institution. I think you could replicate that. The difficulty would be in dealing with State-chartered organizations where you did not already have a Federal regulator like the OCC or the OTS.

Senator REED. Governor Tarullo, your comments, and I might just throw in one other issue. If the Fed is the regulator—and this is a common concern of all of you—you have to be able to sort of work through what is now the deference to functional regulators, which I think we have identified as a problem. So you might put that into your answer, too, Governor.

Mr. TARULLO. Thank you, Senator. People are attracted—particularly once they get out of Government or if they have never been in Government—to neat solutions that look great on paper. I think that anybody who has dealt with this crisis and, indeed, dealt with financial supervision on an ongoing basis, will tell you that the whole point about the financial sector of our economy is that it reaches everywhere and it affects everything.

And if one is looking to a central bank to perform the dual mandate given to it by the Congress of trying to maximize employment and achieve price stability, I do not think there is any way to do that effectively without paying an awful lot of attention to financial stability. And to achieve financial stability, one has to have an influence upon the major kinds of financial activities in the economy, which are, of course, largely though not exclusively being performed by the larger institutions. So the interrelationship between monetary policy aims and the goals of financial stability really undergird the case for our central bank, and central banks around the world, being involved in supervision. That is point one.

Point two, a graphic illustration of what can happen when the central bank is not closely involved in supervision was observed a couple of years ago in the United Kingdom following the decision

to have a single financial services authority with all supervisory responsibility for all kinds of financial institutions. The Bank of England, the central bank, was not involved in supervision at all, and when a significant financial institution—Northern Rock—failed, the Bank of England was not in a position to be able to make judgments about the failure of Northern Rock or the ripple effects within the system. I think it is for that reason that you have a robust debate in the U.K. right now as to whether they need to return some supervisory authority to the Bank of England, I would assume, to coexist with the Financial Services Authority.

Now, there have been some proposals to put everything back in the Bank of England. I personally would not think that would be a particularly good idea.

You raised the question, and let me just address briefly, the issue of ability to get information and to enforce where necessary. I think it is important, if you are going to ask an entity to perform a role of consolidated supervision, to make sure that they have the tools to do so.

Now, as it happens right now there is—and I have no reason to expect there will not be—quite a good relationship between the Fed and the Comptroller with respect to banks within holding companies. But we need to make sure that some kinds of information that are not gathered in bank supervision or, for that matter, certainly supervision of other kinds of regulated entities—insurance entities or securities entities—can, if necessary, be obtained in order to provide the kind of supervisory oversight of the whole institution that you are asking about or looking for.

I do not personally anticipate that there is going to be much utilization of such an authority, but I think you do have to have that kind of back-up.

Senator REED. I have gone way over my time and I—

Mr. DUGAN. Just very quickly—

Senator REED. I am abusing the—

Mr. DUGAN. Just if I could very quickly respond, just to that last point. On the functional regulator point, it may go too far the way it is now, but the way the Administration has proposed it has pushed it too far in the other direction so that you could override the authority of the primary supervisor and that is too much.

Senator REED. Pointed noted. Thank you, my colleagues.

Chairman DODD. Thank you.

Senator Martinez.

Senator MARTINEZ. Thank you, Mr. Chairman.

Good morning to all of you and thank you for being here. I want to ask a question about the proposal of the Administration regarding the elimination of restrictions to interstate banking for national and State banks. I know that a lot of community bankers in Florida would be greatly concerned about that and I wonder if aggressive branching didn't contribute to excessive risk taking in a desire to increase market share, which, in fact, may have had a lot to do with a lot of the problems we have seen lately.

So would a limit on branch banking, how would it change the competitive landscape? Madam Chair?

Ms. BAIR. Senator, the FDIC has not taken a position on that particular provision. I do know that there are several community

bankers that are concerned about it, but I am sorry, we don't have a corporate position on it.

Senator MARTINEZ. Does anyone else care to comment?

Mr. DUGAN. I do not think it would be a good idea to reimpose limits on interstate branching. Right now, there are some limits left on the first branch into a State. But basically, the decades-long restrictions gradually evolved over the years to permit interstate branching and I think it did permit more diversification geographically which was helpful in some circumstances. I personally would not be in favor of further limits.

Senator MARTINEZ. Any other thoughts on the matter? I guess—

Mr. TARULLO. I would just say, Senator, that you alluded to circumstances in which interstate operations became a problem, and I think that can be the case. But that is where it is important to focus upon the business model of the entity in question. It ought not to be allowed to engage in unsafe and unsound practices, whether they involve excessive branching that is unsupported by a sound business plan or other practices.

Mr. BOWMAN. I would just simply point out the fact that thrifts do currently enjoy the ability to branch interstate without restriction, and in terms of the impact upon the community banks, my impression has been that that privilege that thrifts currently enjoy has had some impact, but I am not certain how great.

Senator MARTINEZ. My colleague from Montana brought up the testimony that we have in writing from Mr. Ludwig, and I wanted to go into another area of his testimony that I found very interesting. He makes the point, and I am sure he could make it much better than I if he were making it, which he may get a chance to do later, but that he would suggest avoiding a two-tier regulatory system that elevates the largest "too-big-to-fail" institutions over smaller institutions, and he makes the point that perhaps there would be also two-tier regulators, the best regulators in one system, the others in another, and so anyway, he would urge not to create a "too-big-to-fail" category because it would, in fact, be contrary to what he thinks would be the best interest of not creating a bias in the system that would be in favor of those institutions considered too big to fail at the expense of those that were not viewed too big to fail. Again, could I just get a comment from each of you on that.

Ms. BAIR. Well, I think there are a couple of questions there. One is whether there should be so-called "Tier 1" entities that are officially designated as too-big-to-fail, regardless of who regulates them. There may be some combination of OCC and Federal Reserve Board oversight. And second, whether, as part of regulatory consolidation, you want to have a regulator based on size as opposed to charter.

I think on the former, we have some concerns about designating institutions formally as Tier 1. I think you can probably say who is not, based on asset size—who may not be systemic. But I think to have a clear line of who is systemically important, does contribute to moral hazard. Especially if you don't have a resolution mechanism, it would be quite problematic. But I do believe the as-

sumption is to have stronger capital and leverage constraints for those very large institutions than for the smaller institutions.

In terms of bank regulation, unlike consolidated holding company supervision, I think you should maintain a Federal charter and a State charter. That generally breaks out along size lines, but not always. We have some fairly large State-chartered entities. The OCC has many community banks, as well. But the charter choice, I think, is good to maintain—not different regulatory policies, but policies that are perhaps more reflective of local conditions. With State charters, I think having some sensitivity and more immediacy of being able to deal with a State-level banking supervisor is helpful. So I would maintain regulation based on State or Federal chartering as opposed to employing size limitations.

Senator MARTINEZ. I know we have a vote and I don't know how much time we have left, so I will leave it at that, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair.

I wanted to start by asking, Governor, it is my understanding that some of the problems at Citigroup and other major institutions resulted from moving risky activities back and forth between the holding company and the national bank to minimize supervision. So my question is whether by creating a similar structure, but instead of the Fed and the OCC it would be the Fed and the NBS, National Bank Supervisor, whether we are creating the same risk in the new system of moving activities back and forth.

Mr. TARULLO. Senator, I think under any approach, you must have a common set of requirements across the system which minimize the opportunities for regulatory arbitrage. That means within institutions, and it also means between regulated institutions and nonregulated institutions.

I would say, without talking about any specific institution, there certainly were circumstances in which institutions may have taken advantage of different applicable capital requirements, or of bundling things in one form and moving them around the entity and that part of what needs to be done is to take regulatory steps that minimize those opportunities.

Senator Vitter was asking earlier about bringing off-balance sheet assets back onto the balance sheet. That is one way to combat regulatory arbitrage.

Senator MERKLEY. Well, let me just ask this. Do you think it would make more sense to have the holding companies and the banks under the same regulatory agency?

Mr. TARULLO. I don't, actually. Now, with respect to smaller holding companies, particularly those that have only a bank—it is basically a shell and there is a bank, there are no other entities—the amount of additional holding company supervision is actually quite modest. As the bank holding company picks up additional activities—if it does any of its own capital raising, if it has even a small additional subsidiary, if it does some management at the holding company level—that is when an independent scrutiny of those activities seems to me valuable.

As you get to an even bigger institution, an even more complex institution, it does seem as though the task becomes more special-

ized because you are now looking not just at immediate impacts on the bank—although that is important because we want to protect the deposit insurance fund—you now, as we have learned in this crisis, also need to examine how the whole entity, can be creating risk in and of itself. That involves different kinds of activities, different kinds of regulated entities that are, as you say, moving things back and forth or acting in parallel, and that is where I think you do need a different approach which looks at the holding company as an integrated whole, supplementing and complementing the rigorous functional regulation that takes place in the subsidiaries.

Senator MERKLEY. Yes. Please be very quick, because I want to get in my second question.

Mr. DUGAN. OK, I will. I would say the one area, as I mentioned earlier. I do think there are times where there are activities going on in the bank and the holding company that are the same types of activities but they are subject to different levels of supervision. We ought to try to fix that.

Ms. BAIR. I would just say two things. We have suggested in prior testimony that large institutions have their own resolution plans so that they could be liquidated very quickly if they got into trouble and that a key to this would be greater legal separateness of the insured depository institution and what is in the insured depository institution *versus* what is not. Our resolution process is very complicated now with these large institutions because of the interrelationships between the bank and the nonbank activities. It is hard—you are right—to sometimes tell the difference.

There is a provision called 23(a), which is designed to protect banks from being used as sources of strength for the holding company. We are consulted by the Federal Reserve Board regarding requests for exceptions to the 23(a) restrictions. However, the Fed has the sole authority to approve these requests that can move more higher-risk assets into banks where they are funded with insured deposits. So in terms of an incremental step, and I think that this is no surprise to the Federal Reserve Board, we would very much like to have a statutory role in the 23(a) approval process because this does increase our exposure.

Chairman DODD. Let me interrupt here. I want to make sure I get Senator Bennett in before the vote.

Senator MERKLEY. Not at all, Mr. Chairman.

Chairman DODD. I thank you very much, Senator Merkley. We will leave the record open for further questions, by the way, for all of you.

Senator Bennett.

Senator BENNETT. Thank you very much. Probably, given the time, this will be more of a statement that you can ponder than questions that I want answers to, but I would like to get some answers later on.

It will come as no surprise that I want to talk about ILCs, and no one has discussed the ILC charter in their written testimony. Let us point out that the growth of ILCs over the last 20 years has been one of the great successes in the financial services markets. They are the best capitalized and safest banks in the country. They were in no part a contributor to the financial crisis. They provide

credit in places that it has not been available before, niche markets, a diverse set of products, and the Administration's proposal says, let us eliminate them.

Now, I find that incredible, that something—we talk about Consecro, Lehman Brothers, CIT. All had ILCs, and as they were wound down, the ILCs were the assets that were the crown jewels. The ILCs were the assets that had the most value. And yet the proposal is, let us eliminate them. Let us eliminate the charter.

Now, Mr. Tarullo, you made a comment that the center of this crisis is too big to fail and much of this discussion has been in that area of "too big to fail." May I respectfully suggest that the center of the crisis is not "too big to fail." "Too big to fail" is a manifestation that came out of the center of the crisis, and to put it in my very much layman's terms, the crisis was caused because of this game of musical chairs with respect to risk. And we built more and more risk into the system because while the music was playing, more and more institutions passed the risk on to somebody else thinking, to use the phrase that Sheila used, I have no skin in this game anymore, this game being this particular instrument.

And you go with the change. It starts with the borrower. He has no risk whatsoever because there is no equity in the house. He is getting a 100 percent loan. Sometimes it is a liar loan. The broker who arranges the loan has no risk in the game because he passes it on to the lender. The lender has no risk in the game because he passes it on to the GSE. The GSE has no risk because with the rating agency that has no risk has rated it, and he can pass it on, securitize it, to somebody else. And at every step in the way, in the path, somebody makes money, on a fee, on a commission, whatever it might be. And when the music stops, it turns out that everybody had risk in the game because the whole thing collapses.

And I would like to know a regulator who can focus on that question, not how big you are, but where are you in this chain of musical passing on of risk, musical chairs, if you will, that says somebody can say, no more loans in the beginning. No more liar loans. To brokers, no, you can't pass this on. You have to have some kind of a risk if you get involved in brokering this loan so you will then by market pressure do your job better to see to it that you don't pass it on. To the lender, you maintain some kind of risk as the chain goes forward. The GSE, you maintain some kind of risk. The rating agencies, you will get a risk.

But no one had any risk and the bubble, therefore, grew and grew and grew because everybody was making money with no exposure. And that is the problem that I want to solve with this restructuring rather than working around some of the turf battles that we have talked about.

Now I will go save the republic and you can respond to Chairman Warner.

[Laughter.]

Senator WARNER [presiding]. Does anybody want to respond?

Mr. TARULLO. I would just say a word, Senator, since this will be recorded. I actually agree with everything Senator Bennett said, except I think too-big-to-fail actually plays exactly into the narrative that he gave us. He was talking about the GSEs which were the biggest institutions of all that in the end were regarded "too

big to fail?" It was the GSEs. It is not the only problem, but I think it is a very important problem.

I should be careful about speaking for people on the panel, but certainly making sure that risks are properly assessed by entities—and I would add, making sure that compensation systems and entities accurately reflect the risk that employees are assuming—are important pieces of a reform package.

Ms. BAIR. I will just say, speaking for myself, I would agree that I don't to eliminate the ability to choose a State charter instead of a Federal charter, including an ILC charter. We don't think this was a driver or a contributor to this crisis. We were unaware that the Administration was going to propose that. But again, speaking for myself, I don't see that the ILCs were in any significant way involved in what was going on.

Senator WARNER. Thank you. Let me go ahead and ask my question and then I will call on Senator Schumer. Thank you, Senator Schumer.

I want to go back to where Chairman Dodd started and Senator Tester went with his direction. I am still struggling with this question of whether we do a single end-to-end depository regulator. I think some of you all have raised some legitimate concerns. I know folks on the second panel will perhaps have a different view. Paul Volcker has got a different view. Past chairs have had a different view.

I think, Chairman Bair, your point was valid. How do you make sure that you don't infringe upon your insurance function? I do think you could achieve that by having backup authority and your ability to continue to go in and check particularly those institutions that got into trouble, to check on your ongoing role both as an insurer and what Senator Corker and I have talked about, an expanded resolution authority. I also tend to think that the notion of an enhanced Systemic Risk Council that would include the Fed, that would include the Treasury, that would include the FDIC and this end-to-end bank regulator as well as the SEC and others would give you that ability to have those variety of voices heard.

And I would also just want to raise one other point that we have talked a lot this morning about, the chartering and the ability to change charters, and perhaps prohibiting that. I think you all have raised appropriately those questions. But since each of your organizations have had a licensing division, there is also the question of a selection of a charter when you start an institution.

I guess my first question would be, having that very nature of that choice at the beginning, not switching midstream, but that selection choice at the beginning, doesn't that create regulatory arbitrage? Don't you by default find out who is going to offer you the best deal on the front end and go to that, within your respective agencies, that licensing operation? Doesn't that create the arbitrage issue?

Mr. TARULLO. Well, first, Senator, Sheila and I don't have any authority to charter institutions. The banks we supervise are State chartered.

I would say, though, that—and she can respond to this better than I—because we have similar regulatory requirements—

Senator WARNER. If we could do it fairly quickly, because I do have another question I want to ask—

Mr. TARULLO. Sure. Some of the regulatory requirements are for all institutions and the FDIC has to decide whether to grant insurance to each depository institution, no matter by whom chartered, that wants to be insured. There is a way to contain that kind of arbitrage while permitting the useful, innovative kinds of experimentation that States have engaged in, such as allowing creation of NOW accounts, for example.

Senator WARNER. Mr. Dugan, Mr. Bowman, do you want to—

Mr. DUGAN. I would agree. We do have a licensing function and I would just say that just because you have a choice when you begin operating, it is not necessarily arbitrage. There are differences that go along with the charters in terms of what banks can do and how they can do it, and some prefer to have local, State Government regulation even though we have local examiners on the ground. There is a choice, but the FDIC does grant deposit insurance to all of them.

I don't think that is where the arbitrage issue that we have confronted most has been. It has been after banks have been in operation where someone is facing a problem and they seek to change their charter to avoid a downgrade or an enforcement action. That is the thing that I think troubles all of us a great deal.

Senator WARNER. Mr. Bowman.

Mr. BOWMAN. Yes, I would agree with that. I mean, in terms of people choosing a charter at the outset, the thrift charter is somewhat unique in terms of some of the limitations that are placed upon the kinds of business that an entity would want to engage in. Our thought is that people choose a charter based upon their business plan.

In terms of others who are attempting to switch charters because of some perceived favorable difference between, say, a State charter and a Federal charter, within the State charters you have got 50 to choose from, or 52 to choose from. The Federal charter, you have two, the Federal thrift charter and the national bank charter. Anyone who is looking to avoid or evade some kind of supervisory action or enforcement action, I think as we have talked about here, we as a collective group, interagency basis, have tried to take steps to avoid that from happening or to slow it down, to make sure that it doesn't happen for the wrong reasons.

Senator WARNER. One common theme from all of you has been—and I think accurately—reflecting that a great deal of the source of the crisis has come from the nonbank financial sector. Another issue I am struggling with and would like to get all of your comments on is, assume whichever way, consolidating a single entity or maintaining the current structure, how do we get our arms around this nonbank financial arena? Clearly, one approach the Administration has talked about is on the consumer end, the consumer product end, looking at specific financial products coming from this array of institutions. Another is that if they kind of bump up to the level of becoming systemically risky, the Council, or in the Administration's proposal the Fed would have oversight.

What I am not clear on is should these nonbank—this nonbank financial sector have some level of day-to-day prudential regula-

tion, and I have not seen anybody propose where that—one, is it needed, and two, where that day-to-day prudential regulation in terms of safety and soundness would land. Comments?

Ms. BAIR. You have prudential supervision of banks because of deposit insurance and other vehicles as part of the safety net. With the nonbanks, you do not have that. They are not federally insured.

Senator WARNER. Should you have some?

Ms. BAIR. I don't think you need to. I don't think you need to go that far. I think the consumer abuses for the smaller entities were really more of a significant driver, the lax underwriting which then spilled over into the larger institutions because of the competitive situation it created.

But no, I don't think you do. I think if you have the ability to impose prudential requirements on systemic institutions or systemic practices, then I don't think you need institutional—

Senator WARNER. So the Council up here for systemic and the consumer down here, but no need for—

Ms. BAIR. Yes.

Mr. DUGAN. I generally think that is a daunting challenge to regulate the hundreds of thousands of different financial providers all on a safety and soundness basis. But I think the Administration would do so and have the authority to do so for consumer protection, as you suggested. It doesn't get at what really is, and was, a fundamental issue. To the extent they engage in very banklike functions and there is a safety and soundness issue, like an underwriting standard or downpayment requirements, I would argue that is not really a consumer protection function in its traditional sense—

Senator WARNER. It almost goes to some of the comments Senator Bennett was making about making sure you have got skin in the game—

Mr. DUGAN. Yes. That is the consumer having skin in the game. But my point is, part of the mortgage legislation that passed the House last year had some common standards that I would say are prudential standards that apply. I think that would have been helpful for mortgage providers, but not necessarily all financial providers. So I think there may be some instances where some of that is warranted.

Senator WARNER. But wouldn't Senator Bennett's approach, that if you originated a product, then you have to keep it in there, that is not so much just protecting the consumer, but it may be also protecting this—putting some requirements of safety and soundness on the institution—

Mr. DUGAN. Absolutely.

Senator WARNER. —quasi-prudential.

Mr. DUGAN. Absolutely.

Mr. TARULLO. Senator, I would say a couple of things. First, I do think that the question of where regulation stops, how broadly the perimeter is cast, is an important one going forward. We know that we are not going to have the same problems as we had a few years ago. There are going to be new problems, and that, I think, is what everybody is addressing. How do we stop it?

I would have thought that one of the important roles of a Council, of some sort of an interagency council, is precisely to attend to

issues that don't seem under anybody's regulatory umbrella at that particular moment. If——

Senator WARNER. Beyond just being whether they are systemically risky, down to——

Mr. TARULLO. Well, I think you point out the problem. You have systemically risky institutions addressed, you have regulated institutions that are already regulated, and then you have consumer. But if you have a practice which is troublesome, then there ought to be a mechanism for somebody to be making an evaluation of that practice. And then perhaps if the Council saw that one of its members had authority to regulate, it could suggest it. Congress could also think about giving some sort of default or back-up authority to the Council in the event that no one had——

Senator WARNER. Very quickly, because the senior Senator from New York is anxious.

Mr. BOWMAN. I think, Senator, that you really have hit the nub of the issue, which is the ability to regulate or somehow oversee this group in between the Council and the CFPB. Trust me that whatever scheme might be brought up or passed into legislation, there are very, very creative people out there who are going to look at that legislation, the regulations that are drafted by it and they are going to find a way to get around it, whether it is at the State level, the Federal level, whatever else.

People create businesses every day. They have a business model of where they want to engage in a particular activity. I think the preference for a lot of people is to engage in a particular activity with a minimum of regulation attached to it. So it is a very, very difficult issue.

Senator WARNER. Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman.

I want to thank all of you for being here, very important subject. We have all gathered here today with one common goal, to make our financial regulatory system strong enough to prevent another severe financial crisis from happening. And I have read the written testimony. If I were in your shoes, I would probably make the same arguments. But some might argue there is a bit of turf protection here. That is natural, but it shouldn't be the dominant consideration as we move forward.

Mr. Bowman, in all due respect, almost everyone regards the OTS as having failed in its responsibilities. We have seen institution after institution after institution poorly regulated, and you are saying, keep the OTS. So I think even though, probably again, if I were sitting where you were, with hard-working men and women working for you, I would say, keep my agency, keep all the powers, don't do any consolidation, I think we in the Committee have to see the testimony as coming from at least partially that perspective.

So I would ask you this. There are reasons for one strong, powerful, efficient regulator, and I think people who are objective, who don't have any turf considerations, when they look up from on high, tend to think that should happen in the banking area. There is more discussion in the Systemic Risk Regulator. I think there is a good argument that the insurer should be separate from the regulator because there are different concerns.

So let me ask you this, though, all of you. Here are four arguments for a consolidated regulator. One is that a consolidated regulator would prevent charter shopping, so a bank can't flip its charter and pick up its own regulator—Countrywide did that, remember that, Mr. Bowman?

A hodgepodge of different regulators adds to conflicts in regulation and creates confusing burdens for the banks. We have all heard from institutions who were told one thing by one regulator and another thing by another regulator, each of whom has authority.

Third, a single regulator could keep better tabs of industry-wide risks, dangers, and developments. That is pretty apparent.

And fourth, a single consolidated regulator can eliminate agency and regulatory arbitrage and gaps, and no bank could escape from being held accountable for violations or poor practices.

So my question to you is, do you disagree that one consolidated regulator would avoid these four problems, or have these four benefits, even if you think other mechanisms might be better for other reasons? Who wants to go first?

Mr. TARULLO. I will start, Senator.

Senator SCHUMER. Thank you.

Mr. TARULLO. I would say that each of the four things you mentioned is an important aim. Some of them, like avoiding charter conversion arbitrage, can be addressed short of a single regulator. That is one thing that the four of us at this table have tried to do already.

The only thing I would add to what you say is there are also some costs to going the single regulator route. So one of the costs is that the Fed, for example, loses some insight into how banks are actually functioning, how they are moving money, why the volatility of money is what it is.

I think, also, another potential cost is you have a single all-encompassing regulator and sometimes it loses perspective because it is the only game in town—

Senator SCHUMER. Right. Look, I wouldn't deny there are arguments on the other side, but you would agree that these four arguments make some sense for a consolidated regulator?

Mr. TARULLO. Right. I think a couple of them are stronger than others, but yes.

Senator SCHUMER. Mr. Dugan is shaking his head. You agree?

Mr. DUGAN. Yes, I would agree with that. Those benefits are definitely there and real, I think. This is the right equation. You have to ask, what are the costs, and again, I think there are certain things that the Federal Reserve brings to the table in terms of closeness to the markets and expertise from the open market operations that would be difficult, but not impossible, to replicate, but that are real, and you have to consider that.

And second, as I have mentioned earlier with my colleague for the FDIC, it is hard to be—

Senator SCHUMER. Yes.

Mr. DUGAN. —good at it if you are not doing it all the time, and so you have to take those things into account.

Senator SCHUMER. Ms. Bair.

Ms. BAIR. Yes. I think on the monitoring, if you look at the jurisdictions that had a single regulator, they really weren't any better. If you have a single monopoly regulator, that can contribute to regulatory laxity as opposed to having competition among regulators.

Also, regarding regulatory arbitrage it is not just a matter of picking bank charters. If you don't include securities firms, derivatives dealers, hedge funds, and insurance companies, you still have the ability to choose a business model, on a legal model that would fall outside of the existing regulatory regime. So unless you include all of the various types of financial firms, I think you are going to still have some degree of arbitrage.

Senator SCHUMER. Right. Mr. Bowman.

Mr. BOWMAN. Yes, Senator Schumer. I would agree that the single form of regulator really hasn't proven to be any more effective in terms of what we have now. And I would also be remiss to point if I did not point out that since 2008, 79 financial institutions, State chartered financial institutions have failed—

Senator SCHUMER. Yes.

Mr. BOWMAN. —15 national banks, and 11 thrifts. I think I also need to point out that OTS chartered Countrywide in March of 2007. We had the market impact in August of 2007, and 5 months later, Countrywide was sold to Bank of America. The ability of us as the regulator to impact the events at Countrywide in a 10-month period was very, very limited.

Senator SCHUMER. OK. I have another question if I might, Mr. Chairman, and this relates to the point Mr. Bowman just made. As you said, 54 out of the 69 banks that have failed this year were State chartered banks. This one thing, I mean, I guess it is a historical anomaly, but why the Fed supervises State chartered banks and Mr. Dugan supervises federally chartered banks. I mean, when I first got to the Banking Committee in 1981, I didn't understand that. It just sort of happened, I guess.

And so let me ask both, first Mr. Tarullo, it is true that most of this year's failed banks were not regulated by the national supervisor, the OCC, or the national thrift supervisor, OTS. Explain to me—and then Ms. Bair could answer, as well—could you explain to me why the FDIC and the Fed should keep State chartered banking supervision, particularly if we are giving the Fed more responsibilities in other areas? If you think those functions should be kept apart from the proposed National Bank Supervisor, why shouldn't we at the very least merge FDIC and Fed supervision of the State chartered banks, if you are not going to have the same supervisor? Mr. Tarullo.

Senator WARNER. Excuse me. Could I just, Senator Schumer, just ask the panel all to try to answer quickly because we do want to try to get the second panel, at least get their statements in.

Senator SCHUMER. You know what, I will ask unanimous consent that each panelist be asked to answer that question in writing, because I didn't realize we had a second panel and I was the last one here. Thanks.

[Pause.]

Senator WARNER. It looks like we are going to have to reschedule the second panel, so I am anxious for you all to respond to Senator Schumer's question.

Senator SCHUMER. Mr. Chairman, I am deeply grateful.

[Laughter.]

Mr. TARULLO. Senator, I would start by saying, as you noted, the national banks would be supervised by the OCC as well as chartered. State banks that are members of the Federal Reserve System are supervised by the Fed as their Federal supervisors, and if they are nonmember banks, then their primary Federal regulator is the FDIC.

I think that there are two answers to the question. One is, as you suggest, history. The Comptroller was started in 1863 to create a new national charter and we have had a dual banking system ever since. I think there is probably some concern on the part of State Banking Commissioners that they not have as their overseer at the Federal level the same entity that charters national banks—

Senator SCHUMER. That is a little bit of what we would say in Brooklyn is turf.

[Laughter.]

Mr. TARULLO. It is, there is no question. But I think their concern is, Senator, whether or not there would be the same kind of treatment of national and State chartered institutions.

Second, the question is, are there gains from having the FDIC and the Fed supervising banks as well as performing their other functions, and I would suggest that there are.

Ms. BAIR. I would want to comment on the previous statement that 54 of the 69 banks were State-chartered. There are a lot more State-chartered banks, and a lot of these are very, very small institutions.

Senator SCHUMER. A lot of the biggest failures were under not Mr. Bowman, I don't blame him, but his predecessor's watch.

Ms. BAIR. We also have provided a lot of support for the larger institutions, as well, on an open bank basis. So I think that all needs to be taken into account. I do think—Senator, I know it is confusing that we have these multiple regulators and it is frustrating because it is hard to explain to the public. On the other hand, as a deposit insurer, we find it extremely helpful to have people on the ground in banks all the time. It helps us a lot. It gives us a window into seeing what is going on in banking, what emerging risks there might be.

You are right, we could perhaps pick some of that up through a backup supervisory process, but I think if we were going to shift to that model, give up primary regulation of State chartered banks and go up just to that, we would have to be much more robust and on-site with our backup examination to keep those data points continually into our risk assessment of what our risks are. So that would, in turn, add to regulatory burden.

So I think that supervisor perspective we get by regulating State-chartered banks is very helpful to us in our insurance function.

Mr. BOWMAN. Senator, if I could just add to the confusion, as you know, the OTS is the back-up regulator for State chartered savings associations, so you have a Federal regulator regulating the same charter at the State level.

Senator WARNER. I would like to thank the panel for a very interesting morning and one that has been very helpful, I know, to all the Members.

I want to also apologize to the next panel, Mr. Ludwig, Mr. Carnell, and Mr. Baily. I understand staff will be back to you about rescheduling. We do want to hear your views. I know some of the second panel views perhaps were more sympathetic to the single end-to-end depository regulator and we want to make sure we get those views on the record and get a chance to press questions, as well. But thank you very much of the first panel and we will reschedule the second.

The hearing is adjourned.

[Whereupon, at 11:11 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Thank you Chairman Dodd for holding today's hearing. As we all know, the regulatory structure overseeing U.S. financial markets has proven unable to keep pace with innovative, but risky, financial products; this has had disastrous consequences. Congress is now faced with the task of looking at the role and effectiveness of the current regulators and fashioning a more responsive system.

To date, it appears one of the Committee's biggest challenges will be to create legislation that better protects consumers. I very much look forward to hearing from today's panels of current and former regulators to see if they believe a new agency is needed to better protect consumers, or if consumer protection should remain a function of the prudential regulator.

I am also interested in hearing from the regulators their views on ways to make the regulatory system more effective. For example, does it make sense to eliminate any of the bank charters to streamline the system? Last, I would also like to know from the witnesses if they believe the regulatory gaps that caused our current crisis would be filled by the Administration's regulatory restructuring proposal. We must get this right, and the proposal we craft must target the most pressing problems in our financial regulatory system.

As this Committee works through many issues to fashion what I hope will be a bipartisan proposal that creates an updated system of good, effective regulations that balance consumer protection and allow for sustainable economic growth, I will continue to advocate for increases in transparency, accountability, and consumer protection.

PREPARED STATEMENT OF SENATOR JACK REED

Today's hearing addresses a critical part of this Committee's work to modernize the financial regulatory system—strengthening regulatory oversight of the safety and soundness of banks, thrifts, and holding companies. These institutions are the engine of our economy, providing loans to small businesses and helping families buy homes and cars, and save for retirement. But in recent years, an outdated regulatory structure, poor supervision, and misaligned incentives have caused great turmoil and uncertainty in our financial markets.

Bank regulators failed to use the authority they had to mitigate the financial crisis. In particular, they failed to appreciate and take action to address risks in the subprime mortgage market, and they failed to implement robust capital requirements that would have helped soften the impact of the recession on millions of Americans. Regulators such as the Federal Reserve also failed to use their rule-making authority to ban abusive lending practices until it was much too late. I will work with my colleagues to ensure that any changes to the financial system are focused on these failings in order to prevent them from reoccurring (including by enhancing capital, liquidity, and risk management requirements).

Just as importantly, however, we have to reform a fragmented and inefficient regulatory structure for prudential oversight. Today we have an inefficient system of five Federal regulators and State regulators that share prudential oversight of banks, thrifts, and holding companies. This oversight has fallen short in many significant ways. We can no longer ignore the overwhelming evidence that our system has led to problematic charter shopping among institutions looking to find the most lenient regulator, and has allowed critical market activities to go virtually unregulated.

Regulators under the existing system acted too slowly to stem the risks in the subprime mortgage market, in large part because of the need to coordinate a response among so many supervisors. The Federal Reserve itself has acknowledged that the different regulatory and supervisory regimes for lending institutions and mortgage brokers made monitoring such institutions difficult for both regulators and investors.

It is time to reduce the number of agencies that share responsibility for bank oversight. I support the Administration's plan to merge the Office of the Comptroller of the Currency and the Office of Thrift Supervision, but I think we should also seriously consider consolidating all Federal prudential bank and holding company oversight. Right now, a typical large holding company is overseen by the Federal Reserve or the Office of Thrift Supervision at the holding company level, and then the banks and thrifts within the company can be overseen by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and often many others.

Creating a new consolidated prudential regulator would bring all such oversight under one agency, streamlining regulation and reducing duplication and gaps be-

tween regulators. It would also bring all large complex holding companies and other systemically significant firms under one regulator, allowing supervisors to finally oversee institutions at the same level as the companies do to manage their own risks.

I appreciate the testimony of the witnesses today and I look forward to discussing these important issues.

PREPARED STATEMENT OF SHEILA C. BAIR
CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

AUGUST 4, 2009

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

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

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

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

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

Gaps existed in the regulation and supervision of commercial banks—especially in the area of consumer protection—and regulatory arbitrage occurred there as well. Despite the gaps, bank regulators maintained minimum standards for the regulation of capital and leverage that prevented many of the excesses that built-up in the shadow financial sector.

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

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

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

Effects of the Single Regulator Model

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

The prospect of a unified supervisory authority is alluring in its simplicity. However, there is no evidence that shows that this regulatory structure was better at avoiding the widespread economic damage that has occurred over the past 2 years. The financial systems of Austria, Belgium, Hungary, Iceland and the United Kingdom have all suffered in the crisis despite their single regulator approach. Moreover, it is important to point out that the single regulator system has been adopted in countries that have highly concentrated banking systems with only a handful of very large banks. In contrast, our system, with over 8,000 banks, needs a regulatory and supervisory system adapted to a country of continental dimensions with 50 separate States, with significantly different economies, and with a multiplicity of large and small banks.

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

The Dual Banking System

Historically, the dual banking system and the regulatory competition and diversity that it generates has been credited with spurring creativity and innovation in financial products and the organization of financial activities. State-chartered institutions tend to be community-oriented banks that are close to their communities' small businesses and customers. They provide the funding that supports economic growth and job creation, especially in rural areas. They stay close to their customers, they pay special personal attention to their needs, and they are prepared to work with them to solve unanticipated problems. These community banks also

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

are more accountable to market discipline in that they know their institution will be closed if they become insolvent rather than being considered “too big to fail.”

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

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

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

The Deposit Insurance System

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

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

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

Regulatory Capture

The single regulator approach greatly enhances the risk of regulatory capture should this regulator become too closely tied to the goals and operations of the regulated banks. This danger becomes much more pronounced if the regulator is focused on the needs and problems of large banks—as would be highly likely if the single regulator is reliant on size-based fees for its funding. The absence of the existence of other regulators would make it much more likely that such a development would go undetected and uncorrected since there would be no standard against which the actions of the single regulator could be compared. The end result would be that the damage to the system would be all the more severe when the problems produced by regulatory capture became manifest.

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

Closing the Supervisory Gaps

As discussed above, the unified supervisor model does not provide a solution to the fundamental causes of the economic crisis, which included regulatory gaps between banks and nonbanks and insufficiently proactive supervision. As a result of

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

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

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

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

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

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

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

nation of the prudential and systemic approaches will be vital to improving supervision at both the bank and systemic level.

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

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

Conclusion

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

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

I would be pleased respond to your questions.

PREPARED STATEMENT OF JOHN C. DUGAN

COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY

AUGUST 4, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I appreciate this opportunity to discuss the modernization of financial services regulation in the context of the Administration's Proposal for regulatory reform.¹ The events of the last 2 years—including the unprecedented distress and failure of financial firms, the accumulation of toxic subprime mortgage assets in our financial system, and the steep rise in foreclosures—have exposed gaps and weaknesses in our regulatory framework. The Proposal put forward by the Treasury Department for strengthening that framework is thoughtful and comprehensive, and I support many of its proposed reforms. But I also have significant concerns with two parts of it, *i.e.*, (1) the proposed broad authority of the Federal Reserve, as systemic risk regulator, to override authority of the primary prudential banking supervisor; and (2) the elimination of uniform national consumer protection standards for national banks in connection with establishing the newly proposed Consumer Financial Pro-

¹ See, U.S. Department of the Treasury, "Financial Regulatory Reform—A New Foundation: Rebuilding Financial Supervision and Regulation" (June 2009) (the "Proposal"), available at www.financialstability.gov/docs/regs/FinalReport.web.pdf. Treasury also has released legislative language to implement most components of the Proposal. That proposed legislation is available at www.treas.gov/initiatives/regulatoryreform.

tection Agency (CFPA), and the transfer of all existing consumer protection examination and enforcement from the Federal banking agencies to the new CFPA. Both concerns relate to the way in which important new authorities would interact with the essential functions of the dedicated prudential banking supervisor.

My testimony begins with a brief summary of the key parts of the Proposal we generally support. The second section focuses on the topics pertaining to regulatory structure on which the Committee has specifically invited our views; this portion includes a discussion of the Federal Reserve's role and authority. The last section addresses our second area of major concern—uniform national standards and the CFPA.

I. Key Provisions Supported by the OCC

We believe many of the Administration's proposed reforms will strengthen the financial system and help prevent future market disruptions of the type we witnessed last year, including the following:

- *Establishment of a Financial Stability Oversight Council.* This council would consist of the Secretary of the Treasury and all of the Federal financial regulators, and would be supported by a permanent staff. Its general role would be to identify and monitor systemic risk, and it would have strong authority to gather the information necessary for that mission, including from any entity that might pose systemic risk. We believe that having a centralized and formalized mechanism for gathering and sharing systemically significant information, and making recommendations to individual regulators, makes good sense. It also could provide a venue or mechanism for resolving differences of opinions among regulators.
- *Enhanced authority to resolve systemically significant financial firms.* The Federal Deposit Insurance Corporation (FDIC) currently has broad authority to resolve a distressed systemically significant depository institution in an orderly manner. No comparable resolution authority exists for large bank holding companies, or for systemically significant financial companies that are not banks, as we learned painfully with the problems of such large financial companies as Bear Stearns, Lehman Brothers, and AIG. The Proposal would extend resolution authority like the FDIC's to such nonbanking companies, while preserving the flexibility to use the FDIC or another regulator as the receiver or conservator, depending on the circumstances. This is a sound approach that would help maximize orderly resolutions of systemically significant firms.
- *Strengthened regulation of systemically significant firms, including requirements for higher capital and stronger liquidity.* We support the concept of imposing more stringent prudential standards on systemically significant financial firms to address their heightened risk to the system and to mitigate the competitive advantage they could realize from being designated as systemically significant. But these standards should not displace the standard-setting and supervisory responsibilities of the primary banking supervisor with respect to bank subsidiaries of these companies. And in those instances where the largest asset of the systemically significant firm is a bank—as may often be the case—the primary banking supervisor should have a strong role in helping to craft the new standards for the holding company.
- *Changes in accounting standards that would allow banks to build larger loan loss reserves in good times to absorb more losses in bad times.* One of the problems that has impaired banks' ability to absorb increased credit losses while continuing to provide appropriate levels of credit is that their levels of loan loss reserves available to absorb such losses were not as high as they should have been entering the crisis. One reason for this is the currently cramped accounting regime for building loan loss reserves, which is based on the concept that loan loss provisions are permissible only when losses are "incurred." The Proposal calls for accounting standard setters to improve this standard to make it more forward looking so that banks could build bigger loan loss reserves when times are good and losses are low, in recognition of the fact that good times inevitably end, and large loan loss reserves will be needed to absorb increased losses when times turn bad. The OCC strongly supports this part of the Proposal. In fact, I cochaired an international task force under the auspices of the Financial Stability Board to achieve this very objective on a global basis, which we hope will contribute to stronger reserving policy both here and abroad.
- *Enhanced consumer protection.* The Proposal calls for enhanced consumer protection standards for consumer financial products through new rules that would be written and implemented by the new Consumer Financial Protection Agency. The OCC supports strong, uniform Federal consumer protection standards.

While we generally do not have rulewriting authority in this area, we have consistently applied and enforced the rules written by the Federal Reserve (and others), and, in the absence of our own rulewriting authority, have taken strong enforcement actions to address unfair and deceptive practices by national banks. We believe that an independent agency like the CFPB could appropriately strengthen consumer protections, but we have serious concerns with the CFPB as proposed. We believe the goal of strong consumer protection can be accomplished better through CFPB rules that reflect meaningful input from the Federal banking agencies and are truly uniform, rather than resulting in a patchwork of different rules amended and enforced differently by individual States. We also believe that these rules should continue to be implemented by the Federal banking agencies for banks, under the existing, well-established regulatory and enforcement regime, and by the CFPB and the States for nonbank financial providers, which today are subject to different standards and far less actual oversight than federally regulated depository institutions. This is discussed in greater detail below.

- *Stronger regulation of payments systems, hedge funds, and over-the-counter derivatives, such as credit default swaps.* The Proposal calls for significant enhancements in regulation in each of these areas, which we generally support in concept. We will provide more detailed comments about each, as appropriate, once we have had more time to review the implementing legislative language.

II. Regulatory Structure Issues

1. *Proposed Establishment of the National Bank Supervisor and Elimination of the Federal Thrift Charter*

In proposing to restructure the banking agencies, the Proposal appropriately preserves an agency whose only mission is banking supervision. This new agency, the National Bank Supervisor (NBS), would serve as the primary regulator of federally chartered depository institutions, including the national banks that comprise the dominant businesses of many of the largest financial holding companies. To achieve this goal, the Proposal would effectively merge the Office of Thrift Supervision (OTS) into the OCC.

It would eliminate the Federal thrift charter—and also, as I will shortly discuss, the separate treatment of savings and loan holding companies—with all Federal thrifts required to convert to a national bank, a State bank, or a State thrift, over the course of a reasonable transition period. (State thrifts would then be treated as State “banks” under Federal law.) We believe this approach to the agency merger is preferable to one that would preserve the Federal thrift charter, with Federal thrift regulation being conducted by a division of the merged agency. With the same deposit insurance fund, same prudential regulator, same holding company regulator, same branching powers, and a narrower charter (a national bank has all the powers of a Federal thrift plus many others), there would no longer be a need for a separate Federal thrift charter. In addition, the approach in the Proposal avoids the considerable practical complexities and costs of administering two separate statutory and regulatory regimes that are largely redundant in many areas, and needlessly different in others. Finally, the legislation implementing this aspect of the Proposal should be unambiguously clear—as we believe is intended—that the new agency is independent from the Treasury Department and the Administration to the same extent that the OCC and OTS are currently independent.²

2. *Enhancement of the Federal Reserve’s Supervision of Systemically Significant Financial Holding Companies*

The Federal Reserve Board already has strong authority as consolidated supervisor to identify and address problems at large, systemically significant bank holding companies. In the financial crisis of the last 2 years, the absence of a comparable authority with respect to large securities firms, insurance companies, and Government-sponsored enterprises that were not affiliated with banks proved to be an enormous problem, as a disproportionate share of the financial stress in the markets was created by these institutions. The lack of a consistent and coherent regulatory regime applicable to them by a single regulator helped mask problems in these nonbanking companies until they were massive. And gaps in the regulatory regime constrained the Government’s ability to deal with them once they emerged.

²For example, current law provides the OCC with important independence from political interference in decision making in matters before the Comptroller, including enforcement proceedings; provides for funding independent of political control; enables the OCC to propose and promulgate regulations without approval by the Treasury; and permits the agency to testify before Congress without the need for the Administration’s clearance of the agency’s statements.

The Proposal would extend the Federal Reserve's consolidated bank holding company regulation to systemically significant nonbanking companies in the future, which would appropriately address the regulatory gap. However, as discussed below, one aspect of this part of the proposal goes too far, *i.e.*, the new Federal Reserve authority to "override" key functions of the primary banking supervisor, which would undermine the authority—and the accountability—of the banking supervisor for the soundness of the banks that anchor systemically significant holding companies.

3. Elimination of the Thrift Holding Company and Industrial Loan Company Exceptions to Bank Holding Company Act Regulation

Under the law today, companies that own thrifts or industrial loan companies (ILCs) are exempt from regulation under the Bank Holding Company Act. The Proposal would eliminate these exemptions, making these types of firms subject to supervision by the Federal Reserve Board.

Thrift holding companies, unlike bank holding companies, are not subject to consolidated regulation; for example, no consolidated capital requirements apply at the holding company level. This difference between bank and thrift holding company regulation created arbitrage opportunities for companies that were able to take on greater risk under a less rigorous regulatory regime. Yet, as we have seen - AIG is the obvious example—large nonbank firms can present similar risks to the system as large banks. This regulatory gap should be closed, and these firms should be subject to the same type of oversight as bank holding companies.

Companies controlling ILCs also are not subject to bank holding company regulation, but admittedly, ILCs have not been the source of the same kinds of problems as thrift holding companies. For that reason, it may be appropriate to continue to exempt small ILCs from bank holding company regulation. If this approach were pursued, the exemption should terminate once the ILC exceeds a certain size threshold, however, because the same potential risks can arise as with banks. Alternatively, if the ILC exemption were repealed altogether, appropriate grandfathering of existing ILCs and their parent companies should be considered.

4. The Merits of Further Regulatory Consolidation

It is clear that the United States has too many bank regulators. We have four Federal bank regulators, 12 Federal Reserve Banks, and 50 State regulators, nearly all of which have some type of overlapping supervisory responsibilities. This system is largely the product of historical evolution, with different agencies created for different legitimate purposes reflecting a much more segmented financial system from the past. No one would design such a system from scratch, and it is fair to say that, at times, it has not been the most efficient way to establish banking policy or supervise banks.

Nevertheless, the banking agencies have worked hard over the years to make the system function appropriately despite its complexities. On many occasions, the diversity in perspectives and specialization of roles has provided real value. And from the agencies has been a primary driver of recent problems in the banking system.

That said, I recognize the considerable interest in reducing the number of bank regulators. The impulse to simplify is understandable, and it may well be appropriate to streamline our current system. But we ought not approach the task by prejudging the appropriate number of boxes on the organization chart. The better approach is to determine what would be achieved if the number of regulators were reduced. What went wrong in the current crisis that changes in regulatory structure (rather than regulatory standards) will fix? Will accountability be enhanced? Will the change result in greater efficiency and consistency of regulation? Will gaps be closed so that opportunities for regulatory arbitrage in the current system are eliminated? Will overall market regulation be improved?

In testimony provided earlier this year, I strongly urged that Congress, in reforming financial services regulation, preserve a robust, independent bank supervisor that is solely dedicated to the prudential oversight of depository institutions. Banks are the anchor of most financial holding companies, including the very largest, and I continue to believe that the benefits of dedicated, strong prudential supervision are significant—indeed, necessary. Dedicated supervision assures there is no confusion about the supervisor's goals and objectives, and no potential conflict with competing objectives. Responsibility is well defined, and so is accountability. Supervision takes a back seat to no other part of the organization, and the result is a strong culture that fosters the development of the type of seasoned supervisors that are needed to confront the many challenges arising from today's banking business. The strength of national banks at the core of many of the largest financial holding com-

panies has been an essential anchor to the ability of those companies to weather recent financial crises—and to absorb distressed securities and thrift companies.

While there is arguably an agreement on the need to reduce the number of bank regulators, there is no such consensus on what the right number is or what their roles should be. As I have mentioned, we support reducing the number of Federal banking regulators from four to three by effectively merging the OTS into the OCC, leaving just one Federal regulator for federally chartered banks. There are reasonable arguments for streamlining the regulatory structure even further, but there would be advantages and disadvantages at each step.

For example, the number of banking regulators could be further reduced from three to two by creating a single Federal regulator for State-chartered banks, whose Federal supervision is now divided between the Federal Reserve Board and the FDIC, depending on whether the State bank is a member of the Federal Reserve System. Today there is virtually no difference in the regulation applicable to State banks at the Federal level based on membership in the System and thus no real reason to have two different Federal regulators. It would be simpler to have one. Opportunities for regulatory arbitrage—resulting, for example, from differences in the way Federal activities restrictions are administered by one or the other regulator—would be reduced. Policymaking would be streamlined. Fewer decision-makers would have to agree on the implementation of banking policies and restrictions that Congress has required to be carried out on a joint basis.

On the other hand, whichever agency loses supervisory authority over State banks also would lose the day-to-day “window” into the condition of the banking industry that today informs the conduct of other aspects of its mission. This may present a greater problem for the FDIC, which would have much less engagement with the banking sector during periods with few bank failures, especially if the Federal Reserve retained holding company jurisdiction, an issue I discuss below.

Still further consolidation could be achieved by reducing the number of bank regulators to one dedicated prudential supervisor. If this were done, the single Federal supervisor should be structured to be independent from the Treasury Department and headed by a board of directors, with the Chairmen of the FDIC and the Federal Reserve Board serving as board members. This is the simplest, and arguably the most logical, approach. It would afford the most direct accountability—there would be no confusion about which regulator was responsible for the Federal supervision of a bank—and it would end opportunities for regulatory arbitrage. Moreover, it could be done within the framework of the dual banking system by preserving both State and national charters. It would be desirable, however, for the single regulator to maintain separate divisions for the supervision of large and small institutions, given the differences in complexity and types of risk that banks of different sizes present.

The disadvantages of such an approach include removing both the Federal Reserve and the FDIC from day-to-day bank supervision (although that concern would be mitigated for the Federal Reserve to the extent it retained holding company regulation). In addition, States may be concerned that the State charter would be significantly less attractive if the same Federal regulator supervised both State and Federal institutions, especially if State-chartered institutions were required to pay for Federal supervision in addition to the assessments charged by the State (although that issue could be addressed separately).

Finally, the Committee has asked whether a consolidated prudential bank supervisor also could regulate the holding company. While this could be done, and has significant appeal with respect to small and “bank-only” holding companies, there would be significant issues involved with such an approach in the case of the largest companies where the challenges would be the greatest.

Little need remains for separate holding company regulation where the bank is small or where it is the holding company’s only, or dominant, asset. (The previously significant role of the Federal Reserve, as holding company supervisor, in approving new activities was dramatically reduced by the provisions in the Gramm-Leach-Bliley Act that authorized financial holding companies and specifically identified and approved in advance the types of activities in which they could engage.) For these firms, the holding company regulator’s other authorities are not necessary to ensure effective prudential supervision to the extent that they duplicate the Federal prudential supervisor’s authority to set standards, examine, and take appropriate enforcement action with respect to the bank. Elimination of a separate holding company regulator thus would eliminate duplication, promote simplicity and accountability, and reduce unnecessary compliance burden for institutions as well.

The case is harder and more challenging for the very largest bank holding companies engaged in complex capital markets activities, especially where the company is engaged in many, or predominantly, nonbanking activities, such as securities and

insurance. Given its substantial role and direct experience with respect to capital markets, payments systems, the discount window, and international central banking, the Federal Reserve Board provides unique resources and perspective to supervision. Eliminating the Board as holding company regulator would mean losing the direct effect of that expertise. The benefits of the different perspectives of holding company regulator and prudential regulator would be lost. The focus of a dedicated, strong prudential banking supervisor could be significantly diluted by extending its focus to nonbanking activities. It also would take time for the consolidated banking supervisor to acquire and maintain a comparable level of expertise, especially in nonbanking activities.

5. Delineation of Responsibilities Between the Systemic Supervisor and Prudential Supervisor

If, as under the Administration's Proposal, the Board is the systemic holding company supervisor, then it is essential that clear lines be drawn between the Board's authority and the authority of the prudential banking supervisor. As I will explain, the Proposal goes too far in authorizing the systemic supervisor to override the prudential supervisor's role and authorities.

The Proposal would establish the Federal Reserve Board as the systemic supervisor by providing it with enhanced, consolidated authority over a "Tier 1" financial holding company—that is, a company that poses significant systemic risk—and all of its subsidiaries. In essence, this structure builds on and expands the current system for supervising bank holding companies, where the Board already has consolidated authority over the company, and the prudential bank supervisor is responsible for direct bank supervision.

In practice, many of the companies likely to be designated as Tier 1 financial holding companies will have at their heart very large banks, many of which are national banks. Because of their core role as financial intermediaries, large banks have extensive ties to the "Federal safety net" of deposit insurance, the discount window, and the payments system. Accordingly, the responsibility of the prudential bank supervisor must be to ensure that the bank remains a strong anchor within the company as a whole. Indeed, this is our existing responsibility at the OCC, which we take very seriously through our continuous on-site supervision by large teams of resident examiners in all of our largest national banks. As a result, the bank is by far the most intensively regulated part of the largest bank holding companies, which has translated into generally lower levels of losses of banks within the holding company *versus* other companies owned by that holding company—including those large bank holding companies that have sustained the greatest losses.

In the context of regulatory restructuring for systemically significant bank holding companies, preserving the essential role of the prudential supervisor of the bank means that its relationship with the systemic supervisor should be complementary; it should not be subsumed or overtaken by the systemic supervisor. Conflating the two roles undermines the bank supervisor's authority, responsibility, and accountability. Moreover, it would impose major new responsibilities on and further stretch the role of the Board.

Parts of the Proposal are consistent with this type of complementary relationship between the Board and the prudential bank supervisor. For example, the Board would be required to rely, as far as possible, on the reports of examination prepared by the prudential bank supervisors. This approach reflects the practical relationship that the OCC has with the Board today, a relationship that works, in part because the lines of authority between the two regulators are appropriately defined. And it has allowed the Board to use and rely on our work to perform its role as supervisor for complex banking organizations that are often involved in many businesses other than banking. It is a model well suited for use in a new regulatory framework where the Board assumes substantial new responsibilities, including potential authority over some Tier 1 companies that do not have bank subsidiaries at all.

In one crucial respect, however, the Proposal departs dramatically from that model and is not consistent with its own stated objective of maintaining a robust, responsible, and independent prudential supervisor that will be accountable for its safety and soundness supervision. That is, the Proposal provides the Board with authority to establish, examine, and enforce more stringent standards with respect to the "functionally regulated" subsidiaries of Tier 1 financial holding companies—which under the proposal would include bank subsidiaries—in order to mitigate systemic risk posed by those subsidiaries. This open-ended authorization would allow the Board to impose customized requirements on virtually any aspect of the bank's operations at any time, subject only to a requirement for "consultation" with the Secretary of the Treasury and the bank's primary Federal or State supervisor. This approach is entirely unnecessary and unwarranted in the case of banks already sub-

ject to extensive regulation. It would fundamentally alter the relationship between the Board and the bank supervisor by superseding the bank supervisor's authority over bank subsidiaries of systemically significant companies, and would be yet another measure that concentrates more authority in, and stretches the role of, the Board.

In addition, while the Proposal centralizes in the Board more authority over Tier 1 financial holding companies, it does not address the current, significant gap in supervision that exists within bank holding companies. In today's regulatory regime, a bank holding company may engage in a particular banking activity, such as mortgage lending, either through a subsidiary that is a bank or through a subsidiary that is not a bank. If engaged in by the banking subsidiary, the activity is subject to required examination and supervision on a periodic basis by the primary banking supervisor. However, if it is engaged in by a nonbanking subsidiary, it is potentially subject to examination by the Federal Reserve, but regular supervision and examination is not required. As a policy matter, the Federal Reserve had previously elected not to subject such nonbanking subsidiaries to full bank-like examination and supervision on the theory that such activities would inappropriately extend "the safety net" of Federal protections from banks to nonbanks.³ The result has been the application of uneven standards to bank and nonbank subsidiaries of bank holding companies. For example, in the area of mortgage lending, banks were held to more rigorous underwriting and consumer compliance standards than nonbank affiliates in the same holding company. While the Board has recently indicated its intent to increase examination of nonbank affiliates, it is not clear that such examinations will be required to be as regular or extensive as the examination of the same activities conducted in banks.

I believe that such differential regulation and supervision of the same activity conducted in different subsidiaries of a single bank holding company—whether in terms of safety and soundness or consumer protection—doesn't make sense and is an invitation to regulatory arbitrage. Indeed, leveling the supervision of all subsidiaries of a bank holding company takes on added importance for a "Tier 1" financial holding company because, by definition, the firm as a whole presents systemically significant risk.

One way to address this problem would be to include in legislative language an explicit direction to the Board to actively supervise nonbanking subsidiaries engaged in banking activities in the same way that a banking subsidiary is supervised by the prudential supervisor, with required regular exams. Of course, adding new required responsibilities for the direct supervision of more companies may serve as a distraction both from the Board's other new assignments under the Proposal as well as the continuation of its existing responsibilities.

An alternative approach that may be preferable would be to assign responsibility to the prudential banking supervisor for supervising certain nonbank holding company subsidiaries. In particular, where those subsidiaries are engaged in the same business as is conducted, or could be conducted, by an affiliated bank—mortgage or other consumer lending, for example—the prudential supervisor already has the resources and expertise needed to examine the activity. Affiliated companies would then be made subject to the same standards and examined with the same frequency as the affiliated bank. This approach also would ensure that the placement of an activity in a holding company structure could not be used to arbitrage between different supervisory regimes or approaches.

III. The Proposed Consumer Financial Protection Agency and the Elimination of Uniform National Standards for National Banks

Today's severe consumer credit problems can be traced to the multiyear policy of easy money and easy credit that led to an asset bubble, with too many people getting loans that could not be repaid when the bubble burst. With respect to these loans—especially mortgages—the core problem was lax underwriting that relied too heavily on rising house prices. Inadequate consumer protections—such as inadequate and ineffective disclosures—contributed to this problem, because in many cases consumers did not understand the significant risks of complex loans that had seductively low initial monthly payments. Both aspects of the problem—lax under-

³ See, e.g., Chairman Alan Greenspan, "Insurance Companies and Banks Under the New Regulatory Law", Remarks Before the Annual Meeting of the American Council of Life Insurance (November 14, 1999) ("The Gramm-Leach-Bliley Act is designed to limit extensions of the safety net, and thus to eliminate the need to impose banklike regulation on nonbank subsidiaries and affiliates of organizations that contain a bank."), available at www.federalreserve.gov/boarddocs/speeches/1999/19991115.htm.

writing and inadequate consumer protections—were especially acute in loans made by nonbank lenders that were not subject to Federal regulation.⁴

In terms of changes to financial consumer protection regulation, legislation should be targeted to the two types of fundamental gaps that fueled the current mortgage crisis. The first gap relates to consumer protection rules themselves, which were written under a patchwork of authorities scattered among different agencies; were in some cases not sufficiently robust or timely; and importantly, were not applied to all financial services providers, bank or nonbank, uniformly. The second gap relates to implementation of consumer protection rules, where there was no effective mechanism or framework to ensure that nonbank financial institutions complied with rules to the same extent as regulated banks. That is, the so-called “shadow banking system” of nonbank firms, such as finance companies and mortgage brokers, provides products comparable to those provided by banks, but is not subject to comparable oversight. This shadow banking system has been widely recognized as central to the most abusive subprime lending that fueled the mortgage crisis.

A new Consumer Financial Protection Agency could be one mechanism to target both the rulewriting gap and the implementation gap. In terms of the rulewriting gap, all existing consumer financial protection authority could be centralized in the CFPA and strengthened as Congress sees fit, and that authority could be applied to all providers of a particular type of financial product with rules that are uniform. In terms of the implementation gap, the CFPA could be focused on supervision and/or enforcement mechanisms that raise consumer protection compliance for nonbank financial providers to a similar level as exists for banks—but without diminishing the existing regime for bank compliance. And in both cases, the CFPA could be structured to recognize legitimate bank safety and soundness concerns that in some cases are inextricably intertwined with consumer protection—as is the case with underwriting standards.

Unfortunately, the Proposal’s CFPA falls short in addressing these two fundamental consumer protection regulatory gaps. Let me address each in turn.

1. Rulewriting

- a. *Lack of Uniform Rules and National Bank Preemption*—To address the rulewriting gap, the Proposal’s CFPA provides a mechanism for centralized authority and stronger rules that could be applied to all providers of financial products. But the rules would not be uniform; that is, because the Proposal authorizes States to adopt different rules, there could be 50 different standards that apply to providers of a particular product or service, including national banks.

A core principle of the Proposal is its recognition that consumers benefit from uniform rules.⁵ Yet this very principle is expressly undermined by the specific grant of authority to States to adopt different rules; by the repeal of uniform standards for national banks; and by the empowerment of individual States, with their very differing points of view, to enforce Federal consumer protection rules—under all Federal statutes—in ways that might vary from State to State. In effect, the resulting patchwork of Federal-plus-differing-State standards would effectively distort and displace the Federal agency’s rulemaking, even though the CFPA’s rule would be the product of an open public comment process and the behavioral research and evaluative functions that the Proposal highlights.

In particular, for the first time in the nearly 150-year history of the national banking system, federally chartered banks would be subject to this multiplicity of State operating standards, because the Proposal sweepingly repeals the ability of

⁴Some have suggested that the Community Reinvestment Act (CRA) caused the subprime lending crisis. That is simply not true. As the Administration’s Proposal expressly recognizes, and as I have testified before, far fewer problem mortgages were made by institutions subject to CRA—that is, federally regulated depository institutions—than were made by mortgage brokers and originators that were not depository institutions. The Treasury Proposal specifically notes that CRA-covered depository institutions made only 6 percent of recent higher-priced mortgages provided to lower-income borrowers or in areas that are the focus of CRA evaluations. Proposal, *supra*, note 1, at 69–70. Moreover, our experience with the limited portion of subprime loans made by national banks is that they are performing better than nonbank subprime loans. This belies any suggestion that the banking system, and national banks in particular, were any sort of haven for abusive lending practices.

⁵See, e.g., Proposal, *supra* note 1, at 69 (discussing the proposed CFPA, observing that “[f]airness, effective competition, and efficient markets require consistent regulatory treatment for similar products,” and noting that consistent regulation facilitates consumers’ comparison shopping); and at 39 (discussing the history of insurance regulation by the States, which “has led to a lack of uniformity and reduced competition across State and international boundaries, resulting in inefficiency, reduced product innovation, and higher costs to consumers.”).

national banks to conduct any retail banking business under uniform national standards.

This is a profound change and, in my view, the rejection of a national standards option is unwise and unjustified, especially as it relates to national banks. Given the CFPB's enhanced authority and mandate to write stronger consumer protection rules, and the thorough and expert processes described as integral to its rule-making, there should no longer be any issue as to whether sufficiently strong Federal consumer protection standards would be in place and applicable to national banks. In this context there is no need to authorize States to adopt different standards for such banks. Likewise, there is no need to authorize States to enforce Federal rules against national banks—which would inevitably result in differing State interpretations of Federal rules—because Federal regulators already have broad enforcement authority over such institutions and the resources to exercise that authority fully.

More fundamentally, we live in an era where the market for financial products and services is often national in scope. Advances in technology, including the Internet and the increased functionality of mobile phones, enable banks to do business with customers in many States. Our population is increasingly mobile, and many people live in one State and work in another—the case for many of us in the Washington, DC, metropolitan area.

In this context, regressing to a regulatory regime that fails to recognize the way retail financial services are now provided, and the need for an option for a single set of rules for banks with multistate operations and multistate customers, would discard many of the benefits consumers reap from our modern financial product delivery system. The Proposal's balkanized approach could give rise to significant uncertainty about which sets of standards apply to institutions conducting a multistate business, generating major legal and compliance costs, and major impediments to interstate product delivery.

This issue is very real for all banks operating across State lines—not just national banks. Recognizing the importance of preserving uniform interstate standards for all banks operating in multiple States, Congress expressly provided in the “Riegle-Neal II” Act enacted in 1997 that State banks operating through interstate branches in multiple States should enjoy the same Federal preemption and ability to operate with uniform standards as national banks.⁶

Accordingly, repealing the uniform standards option would create fundamental, practical problems for all banks operating across State lines, large or small. For example, there are a number of areas in which complying with different standards set by individual States would require a bank to determine which State's law governs—the law of the State where a person providing a product or service is located, the law of the home State of the bank employing that person, or the law of the State where the customer is located. It is far from clear how a bank could do this based on objective analysis, and any conflicts could result in penalties and litigation in multiple jurisdictions.

Consider the following practical examples of the potential for multiple State standards:

- Different rules regarding allowable terms and conditions of particular products;
- Different standards for how products may be solicited and sold (including the internal organizational structure of the provider selling the product);
- Different duties and responsibilities for individuals providing a particular financial product;
- Different limitations on how individuals offering particular products and services may be compensated;
- Different standards for counterparty and assignee liability in connection with specified products;
- Different standards for risk retention (“skin in the game”) by parties in a chain of origination and sale;
- Different disclosure standards;
- Different requirements, or permissible rates of interest, for bank products; and
- Different licensing and product clearance requirements.

Taking permissible interest rates as an example, today the maximum permissible interest rate is derived from the bank's home State. Under the proposal, States could claim that the permissible rate should be the rate of the State in which the

⁶ 12 U.S.C. §1831a(j); *See, also id.* at 1831d (interest rates; parity for State banks).

customer resides, or the rate of the location where the loan is made, or someplace else. States could also have different rules about the types of charges that constitute “interest” subject to State limits. And States could have different standards for exerting jurisdiction over interest rates, creating the potential for the laws of two or more States to apply to the same transaction. And even if the bank figures all this out for a particular customer, and for all the product relationships it has with the customer, that could all change if the customer moved. Does that mean the customer would have to open a new account to incorporate the new required terms?

Such uncertainties have the real potential to confuse consumers, subject providers to major new potential liabilities, and significantly increase the costs of doing business in ways that will be passed on to consumers. It could also cause product providers to pull back where increased costs erase an already thin profit margin—for example, with “indirect” auto lending across State lines—or where they see unacceptable levels of uncertainty and potential risk.

Moreover, a bank with multistate operations might well decide that the only sensible way to conduct a national business is to operate to the most stringent standard prevailing in its most significant State market. It should not be the case that a decision by one State legislature about how products should be designed, marketed, or sold should effectively replace a national regulatory standard established by the Federal Government based on thorough research and an open and nationwide public comment process.

Finally, subjecting national banks to state laws and state enforcement of Federal laws is a potentially crippling change to the national bank charter and a rejection of core principles that form the bedrock of the dual banking system. For nearly 150 years, national banks have been subject to a uniform set of Federal rules enforced by the OCC, and State banks have been subject to their own States’ rules. This dual banking system has worked, as it has allowed an individual State to serve as a “laboratory” for new approaches to an issue—without compelling adoption of a particular approach by all States or as a national standard. That is, the dual banking system is built on individual States experimenting with different kinds of laws, including new consumer protection laws, that apply to State banks in a given State, but not to State banks in all States and not to national banks. Some of these individual State laws have proven to be good ideas, while others have not. When Congress has believed that a particular State’s experiment is worthwhile, it has enacted that approach to apply throughout the country, not only to all national banks, but to State banks operating in other States that have not yet adopted such laws. As a result of this system, national banks have always operated under an evolving set of Federal rules that are at any one time the same, regardless of the State in which the banks are headquartered, or the number of different States in which they operate. This reliable set of uniform Federal rules is a defining characteristic of the national bank charter, helping banks to provide a broader range of financial products and services at lower cost, which in turn can be passed along to the consumer.

The Proposal’s CFPA, by needlessly eliminating this defining characteristic, will effectively “de-nationalize” the national charter and undermine the dual banking system. What will be the point of a national charter if all banks must operate in every State as if they were chartered in that State? In such circumstances there would be a strong impetus to convert to a State bank regulated by the Federal Reserve in order to obtain the same regulator for the bank and the holding company, while avoiding any additional cost associated with national bank supervision—and that would further concentrate responsibilities in, and stretch the mission of, the Federal Reserve.

In short, with many consumer financial products now commoditized and marketed nationally, it is difficult to understand the sense of replacing the existing, long-standing option of enhanced and reliable Federal standards that are uniform, with a balkanized “system” of differing State standards that may be adopted under processes very different from the public-comment and research-based rulemaking process that the CFPA would employ as a Federal agency.

- b. *Safety and Soundness Implications of CFPA Rulemaking*—The Proposal would vest all consumer protection rulewriting authority in the CFPA, which in turn would not be constrained in any meaningful way by safety and soundness concerns. That presents serious issues because, in critical aspects of bank supervision, such as underwriting standards, consumer protection cannot be separated from safety and soundness. They are both part of comprehensive and effective banking supervision. Despite this integral relationship, the Proposal as drafted would allow the CFPA, in writing rules, to dismiss legitimate safety and soundness concerns raised by a banking supervisor. That is, if a particular CFPA rule conflicts with a safety and soundness standard, the CFPA's views would always prevail, because the legislation provides no mechanism for striking an appropriate balance between consumer protection and safety and soundness objectives.

For example, the CFPA could require a lender to offer a standardized mortgage that has simple terms, but also has a low down payment to make it more beneficial to consumers. That type of rule could clearly raise safety and soundness concerns, because lower down payments are correlated with increased defaults on loans—yet a safety and soundness supervisor would have no ability to stop such a rule from being issued.

In short, as applied to depository institutions, the CFPA rules need to have meaningful input from banking supervisors—both for safety and soundness purposes and because bank supervisors are intimately familiar with bank operations and can help ensure that rules are crafted to be practical and workable. A workable mechanism needs to be specifically provided to incorporate legitimate operational and safety and soundness concerns of the banking agencies into any final rule that would be applicable to insured depository institutions. Moreover, I do not believe it is sufficient to have only one banking supervisor on the agency's board, as provided under the Proposal; instead, all the banking agencies should be represented, even if that requires expanding the size of the board.

2. *Implementation: Supervision, Examination, and Enforcement*

Consumer protection rules are implemented through examination, supervision, and/or enforcement. In this context, the Proposal fails to adequately address the implementation gap I have previously described because it fails to carefully and appropriately target the CFPA's examination, supervision, and enforcement jurisdiction to the literally tens of thousands of nondepository institution financial providers that are either unregulated or very lightly regulated. These are the firms most in need of enhanced consumer protection regulation, and these are the ones that will present the greatest implementation challenges to the CFPA. Yet rather than focus the CFPA's implementation responsibilities on these firms, the Proposal would effectively dilute both the CFPA's and the States' supervisory and enforcement authorities by extending them to already regulated banks. To do this, the Proposal would strip away all consumer compliance examination and supervisory responsibilities—and for all practical purposes enforcement powers as well—from the Federal banking agencies and transfer them to the CFPA. And, although the legislation is unclear about the new agency's responsibilities for receiving and responding to consumer complaints, it would either remove or duplicate the process for receiving and responding to complaints by consumers about their banks.

The likely results will be that: (1) nonbank financial providers will not receive the degree of examination, supervision, and enforcement attention required to achieve effective compliance with consumer protection rules; and (2) consumer protection supervision of banks will become less rigorous and less effective.

In relative terms, it will be easy for the CFPA to adopt consumer protection rules that apply to all providers of financial products and services. But it will be far harder to craft a workable supervisory and enforcement regime to achieve effective implementation of those rules. In particular, it will be a daunting challenge to implement rules with respect to the wide variety and huge number of unregulated or lightly regulated providers of financial services over which the new CFPA would have jurisdiction, *i.e.*, mortgage brokers; mortgage originators; payday lenders; money service transmitters; check cashers; real estate appraisers; title, credit, and mortgage insurance companies; credit reporting agencies; stored value providers; financial data processing, transmission, and storage firms; debt collection firms; investment advisers not subject to SEC regulation; financial advisors; and credit counseling and tax preparation services, among other types of firms. Likewise, it will be daunting to respond to complaints from consumers about these types of firms.

Yet, although the Proposal would give the CFPA broad consumer protection authority over these types of financial product and service providers, it contains no framework or detail for examining them or requiring reports from them—or even

knowing who they are. No functions are specified for the CFPA to monitor or examine even the largest of these nonbank firms, much less to supervise and examine them as depository institutions would be when they engaged in the same activities. No provision is even made for registration with the CFPA so that the CFPA could at least know the number and size of firms for which it has supervisory, examination, and enforcement responsibilities. Nor is any means specified for the CFPA to learn this information so that it may equitably assess the costs of its operations—and lacking that, there is a very real concern that assessments will be concentrated on already regulated banks, for which size and operational information is already available.

In short, the CFPA has a full-time job ahead to supervise, examine, and take enforcement actions against nonbank firms in order to effect their compliance with CFPA rules. In contrast, achieving effective compliance with such rules by banks is far more straightforward, since an extensive and effective supervisory and enforcement regime is already in place at the Federal banking agencies. It therefore makes compelling sense for the new CFPA to target its scarce implementation resources on the part of the industry that requires the most attention to raise its level of compliance—the shadow banking system—rather than also try to assume supervisory, examination, and enforcement functions with respect to depository institutions.

Similarly, State consumer protection resources would be best focused on examining and enforcing consumer protection laws with respect to the nonbank financial firms that are unregulated or lightly regulated—and have been the disproportionate source of financial consumer protection problems. If States targeted their scarce resources in this way, and drew on new examination and enforcement resources of the CFPA that were also targeted in this way, the States could help achieve significantly increased compliance with consumer protection laws by nonbank financial firms. Unfortunately, rather than have this focus, the Proposal's CFPA would stretch the States' enforcement jurisdiction to federally chartered banks, which are already subject to an extensive examination and enforcement regime at the Federal level. We believe this dilution of their resources is unnecessary, and it will only make it more difficult to fill the implementation gap that currently exists in achieving effective compliance of nonbank firms with consumer protection rules.

Finally, I firmly believe that, by transferring all consumer protection examination, supervision, and enforcement functions from the Federal banking agencies to the CFPA, the Proposal would create a supervisory system for banks that would be a less effective approach to consumer protection than the integrated approach to banking supervision that exists today. Safety and soundness is not divorced from consumer protection—they are two aspects of comprehensive bank supervision that are complementary. As evidence of this, attached to my testimony are summaries of our actual supervisory experience, drawn from supervisory letters and examination conclusion memoranda, which show the real life linkage between safety and soundness and consumer protection supervision. These summaries demonstrate that the results would be worse for consumers and the prudential supervision of these banks if bank examiners were not allowed to address both safety and soundness and consumer protection issues as part of their integrated supervision.

Indeed, we believe that transferring bank examination and supervision authority to the CFPA will not result in more effective supervision of banks—or consumer protection—because the new agency will never have the same presence or knowledge about the institution. Our experience at the OCC has been that effective, integrated safety and soundness and compliance supervision grows from the detailed, core knowledge that our examiners develop and maintain about each bank's organizational structure, culture, business lines, products, services, customer base, and level of risk; this knowledge and expertise is cultivated through regular on-site examinations and contact with our community banks, and close, day-to-day focus on the activities of larger banks. An agency with a narrower focus, like that envisioned for the CFPA, would be less effective than a supervisor with a comprehensive grasp of the broader banking business.

Conclusion

The OCC appreciates the opportunity to testify on proposed regulatory reform, and we would be pleased to provide additional information as the Committee continues its consideration of this important Proposal.

**Attachment
to the Statement of John C. Dugan**

**Examples of How Safety and Soundness
and Consumer Protection Supervision are Linked**

Although the Proposal to create the CFPA is intended to implicate only consumer protection and not safety and soundness, and is premised on a neat division of the two disciplines, supervision of the two areas is inextricably linked. In the OCC model, the two disciplines are interwoven, sometimes performed by the same staff, especially in community banks, and sometimes by integrated teams of specialists. In either case, supervision in one area informs the other in important ways.

The following examples are derived from OCC examiners' supervisory letters and examiner conclusion memoranda and actual examination experience.⁷ They demonstrate real-life examples of the interrelationship of safety and soundness and consumer protection supervision in the bank supervision process. This integrated and effective supervisory approach would be dismantled under the Consumer Financial Protection Agency proposal.

EXAMPLE 1: *A safety and soundness examination of mortgage origination practices identified a potentially significant consumer protection issue.*

During a safety-and-soundness examination of the credit scoring models used in mortgage origination at a bank, the OCC's quantitative modeling expert noted that models being developed for future use included variables that raised potential fair lending risks. Because the modeling expert was part of the group within the OCC that provides modeling support for fair lending examinations, the modeling expert was familiar with fair lending law considerations. The OCC expert discussed this issue with the quantitative modelers working for the bank, who articulated technical reasons for the inclusion of the variables, related to building more consistent models. The OCC expert was able to discuss the issues in depth with the bank, helping to identify potential alternatives for use in the scoring model. The bank revised the model under development and potential fair lending issues thus were avoided.

⁷ Supervisory letters typically are provided to bank management at the conclusion of an examination to address exam findings, note violations of law or regulations, or matters requiring attention (MRAs), which are issues that do not necessarily involve violations, but that the OCC requires the bank to nonetheless address. Examiner conclusion memoranda are internal documents prepared at the conclusion of an exam to document examination results.

EXAMPLE 2: *An examination for fair lending compliance risk resulted in an MRA requiring an enterprise-wide consumer protection (fair lending) risk management program.*

During an examination to evaluate the bank's fair lending compliance risk management program and test compliance with fair lending laws and regulations, examiners found that the bank had not designated fair lending as an enterprise-level risk and did not manage fair lending risk cohesively across the company. Although management maintained an enterprise-level fair lending policy statement, a formal enterprise-level risk management program was not in place. Examiners conveyed the expectation that the bank would have a cohesively stated and implemented mission across all business units, with standard monitoring processes and metrics to measure effectiveness. Examiners required management to submit a detailed action plan to address the issues raised.

EXAMPLE 3: *A joint safety and soundness and consumer compliance examination of nontraditional mortgage products identified violations related to consumer protection.*

During a joint safety and soundness and consumer compliance examination of nontraditional mortgage products where the primary objective of the review was to assess compliance with OCC Bulletin 2006-41- *Guidance on Nontraditional Mortgage Product Risks*, examiners also evaluated whether nontraditional mortgage disclosures matched the illustrations set forth in OCC Bulletin 2007-28 – *Illustrations of Consumer Information*. Additionally, examiners conducted a concurrent review of stated income products and loans with low or no documentation to determine if the risks involved in these products were sufficiently mitigated. While the exam focused on both safety and soundness and consumer protection issues, the sole violation noted during the exam involved a consumer protection issue. The option ARM payment change notice did not comply with 12 CFR 226.20(c) because it did not include the new interest rate, the prior interest rate and all other rates that applied since the last payment change. The notice also did not include the corresponding index values. It did not indicate if the new payment disclosed any forgone rate increases or if it would fully amortize the loan over the remaining term. As a result of issues identified by examiners, a corrected disclosure form was created and reviewed by examiners during the examination.

EXAMPLE 4: *A joint safety and soundness and consumer compliance examination of credit cards resulted in an MRA related to consumer protection.*

During a joint safety and soundness and compliance review to assess the adequacy of processes relative to underwriting, account management, collections, and compliance with the credit card Account Management Guidance (OCC Bulletin 2003-1), examiners evaluated credit policies and procedures, controls over a vendor relationship, the quality of MIS, and the bank's marketing plan. Concurrently, examiners also conducted a consumer compliance review that focused on assessing the bank's own testing of controls in place to ensure compliance with the various consumer protection regulations

applicable to credit card lending. While the exam focused on both safety and soundness and consumer protection issues, the sole MRA noted during the exam involved a consumer protection issue. Examiners noted that although the bank had agreed to an action plan for developing appropriate consumer compliance controls, a thorough consumer compliance vendor management program and file testing process had yet to be implemented. Examiners required that the bank develop a comprehensive consumer compliance vendor management program that included file testing for compliance with all applicable consumer protection regulations.

EXAMPLE 5: *Review of a consumer credit unit required an integrated team of safety and soundness, information technology (IT), and consumer compliance examiners.*

During a review of a bank's consumer credit unit, the OCC utilized safety and soundness, IT, and compliance examiners to specifically address the quantity and direction of portfolio credit risk; assess underwriting practices, including compliance with the *Subprime Mortgage Lending* guidance outlined in OCC Bulletin 2007-26; and evaluate collateral valuation methodologies. Examiners also evaluated credit quality assurance reviews, exception tracking systems, and control systems. Other areas assessed in this joint review included model risks associated with the collection and origination scorecards; marketing practices and controls; the adequacy of management information systems (MIS); loss forecasting methodologies, with an emphasis on the ACL process; information technology systems within the bank, with a focus on the consumer credit unit.

EXAMPLE 6: *Review of subprime mortgage products required an integrated team of safety and soundness and consumer compliance examiners.*

During the joint safety and soundness and compliance examination of a bank's subprime mortgage products, the primary objective was to assess the propriety of loan origination and risk management processes. Examiners focused on current underwriting and also reviewed controls established to ensure consumer protection against steering and predatory lending practices. Examiners assessed compliance with banking laws, regulations, and guidance, including recent guidance on subprime products. Examiners tested a sample of subprime loans to assess underwriting and consumer protection processes, reviewed written policies and procedures, and also assessed processes used to measure and monitor subprime mortgage performance.

EXAMPLE 7: *Consumer complaints received by the agency about a third-party service provider triggered a comprehensive review by safety and soundness and consumer compliance examiners of a bank's relationships with that provider*

During a joint safety and soundness and compliance review of a bank's relationships with a third-party service provider, examiners also reviewed other third-party marketing

relationships in existence for the businesses. Examiners reviewed policies and procedures covering due diligence and performance monitoring of third-party marketing relationships. The primary objective was to identify all of the bank's business relationships with this provider and the bank's respective due diligence efforts to monitor and control reputation and compliance/legal risks from these relationships. Products were reviewed to evaluate how they were being marketed, the accuracy and transparency of disclosures to the customer, and whether the products offered value to the consumer. This review was conducted because the third-party provider and its programs were the subject of several recent consumer complaints received by the OCC. It also took into account findings from an earlier credit card UDAP review of marketing, disclosures, and internal controls.

EXAMPLE 8: *A safety and soundness review of a bank's internal audit function found weaknesses in the compliance audit function.*

During an annual review of a bank's internal audit program, safety and soundness examiners focused on evaluating the scope of audit work performed, the effectiveness of following up and validation activities, and the adequacy of management reporting. Test work was completed using the customary integrated approach of having each functional team complete an assessment of audit work in their areas of expertise. The scope of these reviews focused on work paper samples, call program databases, and corrective action databases.

Examiners identified areas for improvement in compliance audit functions. Examiners noted that an overall "state of compliance" for each significant consumer protection regulation would be beneficial to bank executive management in determining compliance risk areas and spending priorities.

The bank's approach to compliance auditing entailed a highly decentralized line of business approach. Examiners noted that related to the lack of an overall compliance roll-up, the compliance audit process would also benefit from improved scoping of higher risk products/services and deeper analysis of activity and associated risks. Because audit testing occurred almost exclusively as part of the line of business audits, examiners noted that few audit resources were dedicated to review specific compliance risks associated with individual products or services.

EXAMPLE 9: *A safety and soundness examination of nontraditional mortgages (NTM) and home equity loans resulted in a series of consumer-protection-related recommendations.*

During a safety and soundness review of a bank's consumer finance unit to assess compliance with regulatory guidances including non-traditional, subprime, and home equity mortgages, examiners assessed the adequacy of risk management oversight and control systems. Examiners specifically targeted underwriting of near-prime broker

originated, interest only mortgage loans, subprime broker originated mortgage loans, and subprime retail mortgage loans. The examiners reviewed risk management MIS, third party monitoring, and mortgage loss mitigation and workout programs. During the review the safety and soundness examiners noted consumer protection issues.

While the combined disclosures provided adequately addressed the requirements indicated in the Statement on Subprime Guidance (OCC Bulletin 2007-26) and in the Interagency NTM guidance, examiners determined that it was based on the proposed, not final illustrations. Additionally, examiners identified that the system which generated the disclosures at the time of application for certain loans was not updated as intended with the combined disclosure.

Examiners made the following consumer protection related recommendations to bank management.

The bank should revise the nontraditional mortgage disclosure, *Consumer Finance Division Comparison of Sample Mortgage Features*, to fully comply with OCC Bulletin 2007-28, provide better consistency with other ARM disclosures, and address computation errors. Additionally, bank management should verify the accuracy of the numbers disclosed in the comparison table. Examiners identified small computational errors in numbers in the table under the interest only 5/1 ARM example and an error in the balloon loan footnote.

Examiners also recommended that quality assurance expand its interest-only mortgage review checklist to verify that the NTM disclosure was provided. Additionally, examiners recommended that the bank verify that all software systems are updated with the most current version of the disclosures when changes occur.

EXAMPLE 10: *During a trust examination, a number of consumer protection issues were identified.*

During a fiduciary review of a bank's personal trust area, trust examiners identified consumer protection MRAs.

Examiners noted that bank management needed to ensure that trust accounts were properly compensated for income lost as a result of bank errors. Examiners identified one account in a sample where an errant transaction resulted in the nominal loss of interest income. The bank did not reimburse the account for the lost income, as required by internal policy. In addition, there was not a process in place to identify errant transactions and ensure that proper compensation is made to an account. Examiners required bank management to compensate the account noted in the sample and identify tools to be used to ensure that similar situations be detected and resolved appropriately going forward.

Examiners further noted that bank management needed to compensate customer accounts for the loss of earnings from the untimely posting of mutual fund dividends and capital gains. Examiners also noted that management needed to establish or modify policies and procedures to define the remedial measures to be taken in similar situations going forward. The untimely posting of payments negatively impacted the accounts involved and benefited the bank. Examiners required bank management to properly compensate all accounts impacted by the posting problems and ensure appropriate policies and procedures were in place to govern recurrences.

PREPARED STATEMENT OF DANIEL K. TARULLO
MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

AUGUST 4, 2009

Chairman Dodd, Ranking Member Shelby, and other Members of the Committee, thank you for your invitation to testify this morning. The financial crisis had many causes, including global imbalances in savings and capital flows, the rapid integration of lending activities with the issuance, trading, and financing of securities, the existence of gaps in the regulatory structure for the financial system, and widespread failures of risk management across a range of financial institutions. Just as the crisis had many causes, the response of policymakers must be broad in scope and multifaceted.

Improved prudential supervision—the topic of today’s hearing—is a necessary component of the policy response. The crisis revealed supervisory shortcomings among all financial regulators, to be sure. But it also demonstrated that the framework for prudential supervision and regulation had not kept pace with changes in the structure, activities, and growing interrelationships of the financial sector. Accordingly, it is essential both to refocus the regulation and supervision of banking institutions under existing authorities and to augment those authorities in certain respects.

In my testimony today, I will begin by suggesting the elements of an effective framework for prudential supervision. Then I will review actions taken by the Federal Reserve within its existing statutory authorities to strengthen supervision of banks and bank holding companies in light of developments in the banking system and the lessons of the financial crisis. Finally, I will identify some gaps and weaknesses in the system of prudential supervision. One potential gap has already been addressed through the cooperative effort of Federal and State banking agencies to prevent insured depository institutions from engaging in “regulatory arbitrage” through charter conversions. Others, however, will require congressional action.

Elements of an Effective Framework for Prudential Supervision

An effective framework for the prudential regulation and supervision of banking institutions includes four basic elements.

First, of course, there must be sound regulation and supervision of each insured depository institution. Applicable regulations must be well-designed to promote the safety and soundness of the institution. Less obvious, perhaps, but of considerable importance, is the usefulness of establishing regulatory requirements that make use of market discipline to help confine undue risk taking in banking institutions. Supervisory policies and techniques also must be up to the task of enforcing and supplementing regulatory requirements.

Second, there must be effective supervision of the companies that own insured depository institutions. The scope and intensity of this supervision should vary with the extent and complexity of activities conducted by the parent company or its nonbank subsidiaries. When a bank holding company is essentially a shell, with negligible activities or ownership stakes outside the bank itself, holding company regulation can be less intensive and more modest in scope. But when material activities or funding are conducted at the holding company level, or when the parent owns nonbank entities, the intensity of scrutiny must increase in order to protect the bank from both the direct and indirect risks of such activities or affiliations and to ensure that the holding company is able to serve as a source of strength to the bank on a continuing basis. The task of holding company supervision thus involves an examination of the relationships between the bank and its affiliates as well as an evaluation of risks associated with those nonbank affiliates. Consolidated capital requirements also play a key role, by helping ensure that a holding company maintains adequate capital to support its groupwide activities and does not become excessively leveraged.

Third, there cannot be significant gaps or exceptions in the supervisory and regulatory coverage of insured depository institutions and the firms that own them. Obviously, the goals of prudential supervision will be defeated if some institutions are able to escape the rules and requirements designed to achieve those goals. There is a less obvious kind of gap, however, where supervisors are restricted from obtaining relevant information or reaching activities that could pose risks to banking organizations.

Fourth, prudential supervision—especially of larger institutions—must complement and support regulatory measures designed to contain systemic risk and the too-big-to-fail problem, topics that I have discussed in previous appearances before

this Committee.¹ One clear lesson of the financial crisis is that important financial risks may not be readily apparent if supervision focuses only on the exposures and activities of individual institutions. For example, the liquidity strategy of a banking organization may appear sound when viewed in isolation but, when examined alongside parallel strategies of other institutions, may be found to be inadequate to withstand periods of financial stress.

Strengthening Prudential Supervision and Regulation

The crisis has revealed significant risk-management deficiencies at a wide range of financial institutions, including banking organizations. It also has challenged some of the assumptions and analysis on which conventional supervisory wisdom has been based. For example, the collapse of Bear Stearns, which at the end was unable to borrow privately even with U.S. Government securities as collateral, has undermined the widely held belief that a company can readily borrow against high-quality collateral, even in stressed environments. Moreover, the growing codependency between financial institutions and markets—evidenced by the significant role that investor and counterparty runs played in the crisis—implies that supervisors must pay closer attention to the potential for financial markets to influence the safety and soundness of banking organizations. These and other lessons of the financial crisis have led to changes in regulatory and supervisory practices in order to improve prudential oversight of banks and bank holding companies, as well as to advance a macroprudential, or systemic, regulatory agenda.

Working with other domestic and foreign supervisors, the Federal Reserve has taken steps to require the strengthening of capital, liquidity, and risk management at banking organizations. There is little doubt that, in the period before the crisis, capital levels were insufficient to serve as a needed buffer against loss, particularly at some of the largest financial institutions, both in the United States and elsewhere. Measures to strengthen the capital requirements for trading activities and securitization exposures—two areas where banking organizations have experienced greater losses than anticipated—were recently announced by the Basel Committee on Banking Supervision. Additional efforts are under way to improve the quality of the capital used to satisfy minimum capital ratios, to strengthen the capital requirements for other types of on- and off-balance-sheet exposures, and to establish capital buffers in good times that can be drawn down as economic and financial conditions deteriorate. Capital buffers, though not easy to design or implement in an efficacious fashion, could be an especially important step in reducing the procyclical effects of the current capital rules. Further review of accounting standards governing valuation and loss provisioning also would be useful, and might result in modifications to the accounting rules that reduce their procyclical effects without compromising the goals of disclosure and transparency.

The Federal Reserve also helped lead the Basel Committee's development of enhanced principles of liquidity risk management, which were issued last year.² Following up on that initiative, on June 30, 2009, the Federal banking agencies requested public comment on new *Interagency Guidance on Funding and Liquidity Risk Management*, which is designed to incorporate the Basel Committee's principles and clearly articulate consistent supervisory expectations on liquidity risk management.³ The guidance reemphasizes the importance of cash flow forecasting, adequate buffers of contingent liquidity, rigorous stress testing, and robust contingent funding planning processes. It also highlights the need for institutions to better incorporate liquidity costs, benefits, and risks in their internal product pricing, performance measurement, and new product approval process for all material business lines, products, and activities.

With respect to bank holding companies specifically, the supervisory program of the Federal Reserve has undergone some basic changes. As everyone is aware, many

¹ See, Daniel K. Tarullo (2009), "Regulatory Restructuring", statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 23, www.federalreserve.gov/newsevents/testimony/tarullo20090723a.htm; and Daniel K. Tarullo (2009), "Modernizing Bank Supervision and Regulation", statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 19, www.federalreserve.gov/newsevents/testimony/tarullo20090319a.htm.

² See, Basel Committee on Banking Supervision (2008), "Principles for Sound Liquidity Risk Management and Supervision" (Basel, Switzerland: Bank for International Settlements, September), www.bis.org/publ/bcbis144.htm.

³ See, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration (2009), "Agencies Seek Comment on Proposed Interagency Guidance on Funding and Liquidity Risk Management", joint press release, June 30, www.federalreserve.gov/newsevents/press/bcreg/20090630a.htm.

of the financial firms that lay at the center of the crisis were not bank holding companies; some were not subject to mandatory prudential supervision of any sort. During the crisis a number of very large firms became bank holding companies—in part to reassure markets that they were subject to prudential oversight and, in some cases, to qualify for participation in various Government liquidity support programs. The extension of holding company status to these firms, many of which are not primarily composed of a commercial bank, highlights the degree to which the traditional approach to holding company supervision must evolve.

Recent experience also reinforces the value of holding company supervision in addition to, and distinct from, bank supervision. Large organizations increasingly operate and manage their businesses on an integrated basis with little regard for the corporate boundaries that typically define the jurisdictions of individual functional supervisors. Indeed, the crisis has highlighted the financial, managerial, operational, and reputational linkages among the bank, securities, commodity, and other units of financial firms.

The customary focus on protecting the bank within a holding company, while necessary, is clearly not sufficient in an era in which systemic risk can arise wholly outside of insured depository institutions. Similarly, the premise of functional regulation that risks within a diversified organization can be evaluated and managed properly through supervision focused on individual subsidiaries within the firm has been undermined further; the need for greater attention to the potential for damage to the bank, the organization within which it operates, and, in some cases, the financial system generally, requires a more comprehensive and integrated assessment of activities throughout the holding company.

Appropriate enhancements of both prudential and consolidated supervision will only increase the need for supervisors to be able to draw on a broad foundation of economic and financial knowledge and experience. That is why we are incorporating economists and other experts from nonsupervisory divisions of the Federal Reserve more completely into the process of supervisory oversight. The insights gained from the macroeconomic analyses associated with the formulation of monetary policy and from the familiarity with financial markets derived from our open market operations and payments systems responsibilities can add enormous value to holding company supervision.

The recently completed Supervisory Capital Assessment Program (SCAP) heralds some of the changes in the Federal Reserve's approach to prudential supervision of the largest banking organizations. This unprecedented process involved, at its core, forward-looking, cross-firm, and aggregate analyses of the 19 largest bank holding companies, which together control a majority of the assets and loans within the financial system. Bank supervisors in the SCAP defined a uniform set of parameters to apply to each firm being evaluated, which allowed us to evaluate on a consistent basis the expected performance of the firms under both a baseline and more-adverse-than-expected scenario, drawing on individual firm information and independently estimated outcomes using supervisory models.

Drawing on this experience, we are prioritizing and expanding our program of horizontal examinations to assess key operations, risks, and risk-management activities of large institutions. For the largest and most complex firms, we are creating an enhanced quantitative surveillance program that will use supervisory information, firm-specific data analysis, and market-based indicators to identify developing strains and imbalances that may affect multiple institutions, as well as emerging risks to specific firms. Periodic scenario analyses across large firms will enhance our understanding of the potential impact of adverse changes in the operating environment on individual firms and on the system as a whole. This work will be performed by a multidisciplinary group composed of our economic and market researchers, supervisors, market operations specialists, and accounting and legal experts. This program will be distinct from the activities of on-site examination teams so as to provide an independent supervisory perspective as well as to complement the work of those teams.

Capital serves as an important bulwark against potential unexpected losses for banking organizations of all sizes, not just the largest ones. Accordingly, internal capital analyses of banking organizations must reflect a wide range of scenarios and capture stress environments that could impair solvency. Earlier this year, we issued supervisory guidance for all bank holding companies regarding dividends, capital repurchases, and capital redemptions.⁴ That guidance also reemphasized the Federal

⁴ See, Board of Governors of the Federal Reserve System (2009), Supervision and Regulation Letter SR 09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies", February 24 (as revised on March 27, 2009), www.federalreserve.gov/boarddocs/srletters/2009/SR0904.htm.

Reserve's long-standing position that bank holding companies must serve as a source of strength for their subsidiary banks.

Commercial real estate (CRE) is one area of risk exposure that has gained much attention recently. We began to observe rising CRE concentrations earlier this decade and, in light of the central role that CRE lending played in the banking problems of the late 1980s and early 1990s, led an interagency effort to issue supervisory guidance directed at the risks posed by CRE concentrations. This guidance, which generated significant controversy at the time it was proposed, was finalized in 2006 and emphasized the need for banking organizations to incorporate realistic risk estimates for CRE exposures into their strategic- and capital-planning processes, and encouraged institutions to conduct stress tests or similar exercises to identify the impact of potential CRE shocks on earnings and capital. Now that weaker housing markets and deteriorating economic conditions have, in fact, impaired the quality of CRE loans at many banking organizations, we are monitoring carefully the effect that declining collateral values may have on CRE exposures and assessing the extent to which banking organizations have been complying with the CRE guidance. At the same time, we have taken actions to ensure that supervisory and regulatory policies and practices do not inadvertently curtail the availability of credit to sound borrowers.

While CRE exposures represent perhaps an "old" problem, the crisis has newly highlighted the potential for compensation practices at financial institutions to encourage excessive risk taking and unsafe and unsound behavior—not just by senior executives, but also by other managers or employees who have the ability, individually or collectively, to materially alter the risk profile of the institution. Bonuses and other compensation arrangements should not provide incentives for employees at any level to behave in ways that imprudently increase risks to the institution, and potentially to the financial system as a whole. The Federal Reserve worked closely with other supervisors represented on the Financial Stability Board to develop principles for sound compensation practices, which were released earlier this year.⁵ The Federal Reserve expects to issue soon our own guidance on this important subject to promote compensation practices that are consistent with sound risk-management principles and safe and sound banking.

Finally, I would note the importance of continuing to analyze the practices of financial firms and supervisors that preceded the crisis, with the aim of fashioning additional regulatory tools that will make prudential supervision more effective and efficient. One area that warrants particular attention is the potential for supervisory agencies to enlist market discipline in pursuit of regulatory ends. For example, supervisors might require that large financial firms maintain specific forms of capital so as to increase their ability to absorb losses outside of a bankruptcy or formal resolution procedure. Such capital could be in contingent form, converting to common equity only when necessary because of extraordinary losses. While the costs, benefits, and feasibility of this type of capital requires further study, policy-makers should actively seek ways of motivating the private owners of banking organizations to monitor the financial positions of the issuing firms more effectively.

Addressing Gaps and Weaknesses in the Regulatory Framework

While the actions that I have just discussed should help make banking organizations and the financial system stronger and more resilient, the crisis also has highlighted gaps and weaknesses in the underlying framework for prudential supervision of financial institutions that no regulatory agency can rectify on its own. One, which I will mention in a moment, has been addressed by the banking agencies working together. Others require congressional attention.

Charter Conversions and Regulatory Arbitrage

The dual banking system and the existence of different Federal supervisors create the opportunity for insured depository institutions to change charters or Federal supervisors. While institutions may engage in charter conversions for a variety of sound business reasons, conversions that are motivated by a hope of escaping current or prospective supervisory actions by the institution's existing supervisor undermine the efficacy of the prudential supervisory framework.

Accordingly, the Federal Reserve welcomed and immediately supported an initiative led by the Federal Deposit Insurance Corporation (FDIC) to address such regulatory arbitrage. This initiative resulted in a recent statement of the Federal Financial Institutions Examination Council reaffirming that charter conversions or other

⁵ See, Financial Stability Forum (2009), FSF Principles for Sound Compensation Practices, April 2, www.financialstabilityboard.org/publications/r_0904b.pdf. The Financial Stability Forum has subsequently been renamed the Financial Stability Board.

actions by an insured depository institution that would result in a change in its primary supervisor should occur only for legitimate business and strategic reasons.⁶ Importantly, this statement also provides that conversion requests should not be entertained by the proposed new chartering authority or supervisor while serious or material enforcement actions are pending with the institution's current chartering authority or primary Federal supervisor. In addition, it provides that the examination rating of an institution and any outstanding corrective action programs should remain in place when a valid conversion or supervisory change does occur.

Systemically Important Financial Institutions

The Lehman experience clearly demonstrates that the financial system and the broader economy can be placed at risk by the failure of financial firms that traditionally have not been subject to the type of consolidated supervision applied to bank holding companies. As I discussed in my most recent testimony before this Committee, the Federal Reserve believes that all systemically important financial firms—not just those affiliated with a bank—should be subject to, and robustly supervised under, a statutory framework for consolidated supervision like the one embodied in the Bank Holding Company Act (BHC Act).

Doing so would help promote the safety and soundness of these firms individually and the stability of the financial system generally. Indeed, given the significant adverse effects that the failure of such a firm may have on the financial system and the broader economy, the goals and implementation of prudential supervision and systemic risk reduction are inextricably intertwined in the case of these organizations. For example, while the strict capital, liquidity, and risk-management requirements that are needed for these organizations are traditional tools of prudential supervision, the supervisor of such firms will need to calibrate these standards appropriately to account for the firms' systemic importance.

Industrial Loan Companies and Thrifts

Another gap in existing law involves industrial loan companies (ILCs). ILCs are State-chartered banks that have full access to the Federal safety net, including FDIC deposit insurance and the Federal Reserve's discount window and payments systems; have virtually all of the deposit-taking powers of commercial banks; and may engage in the full range of other banking services, including commercial, mortgage, credit card, and consumer lending activities, as well as cash management services, trust services, and payment-related services, such as Fedwire, automated clearinghouse, and check-clearing services.

A loophole in current law, however, permits any type of firm—including a commercial company or foreign bank—to acquire an FDIC-insured ILC chartered in a handful of States without becoming subject to the prudential framework that the Congress has established for the corporate owners of other full-service insured banks. Prior to the crisis, several large firms—including Lehman Brothers, Merrill Lynch, Goldman Sachs, Morgan Stanley, GMAC, and General Electric—took advantage of this opportunity by acquiring ILCs while avoiding consolidated supervision under the BHC Act.

The Federal Reserve has long supported closing this loophole, subject to appropriate "grandfather" provisions for the existing owners of ILCs. Such an approach would prevent additional firms from acquiring a full-service bank and escaping the consolidated supervision framework and activity restrictions that apply to bank holding companies. It also would require that all firms controlling an ILC, including a grandfathered firm, be subject to consolidated supervision. For reasons of fairness, the Board believes that the limited number of firms that currently own an ILC and are not otherwise subject to the BHC Act should be permitted to retain their non-banking or commercial affiliations, subject to appropriate restrictions to protect the Federal safety net and prevent abuses.

Corporate owners of savings associations should also be subject to the same regulation and examination as corporate owners of insured banks. In addition, grandfathered commercial owners of savings associations should, like we advocate for corporate owners of ILCs, be subject to appropriate restrictions to protect the Federal safety net and prevent abuses.

Strengthening the Framework for Consolidated Supervision

Consolidated supervision is intended to provide a supervisor the tools necessary to understand, monitor, and, when appropriate, restrain the risks associated with an organization's consolidated or groupwide activities. Risks that cross legal entities

⁶See, Federal Financial Institutions Examination Council (2009), "FFIEC Issues Statement on Regulatory Conversions", press release, July 1, www.ffiec.gov/press/pr070109.htm.

and that are managed on a consolidated basis cannot be monitored properly through supervision directed at any one, or even several, of the legal entity subdivisions within the overall organization.

To be fully effective, consolidated supervisors need the information and ability to identify and address risks throughout an organization. However, the BHC Act, as amended by the so-called “Fed-lite” provisions of the Gramm-Leach-Bliley Act, places material limitations on the ability of the Federal Reserve to examine, obtain reports from, or take actions to identify or address risks with respect to both nonbank and depository institution subsidiaries of a bank holding company that are supervised by other agencies. Consistent with these provisions, we have worked with other regulators and, wherever possible, sought to make good use of the information and analysis they provide. In the process, we have built cooperative relationships with other regulators—relationships that we expect to continue and strengthen further.

Nevertheless, the restrictions in current law still can present challenges to timely and effective consolidated supervision in light of, among other things, differences in supervisory models—for example, between the safety and soundness approach favored by bank supervisors and the approaches used by regulators of insurance and securities subsidiaries—and differences in supervisory timetables, resources, and priorities. Moreover, the growing linkages among the bank, securities, insurance, and other entities within a single organization that I mentioned earlier heighten the potential for these restrictions to hinder effective groupwide supervision of firms, particularly large and complex organizations. To ensure that consolidated supervisors have the necessary tools and authorities to monitor and address safety and soundness concerns in all parts of an organization on a timely basis, we would urge statutory modifications to the Fed-lite provisions of the Gramm-Leach-Bliley Act. Such changes, for example, should remove the limits first imposed in 1999 on the scope and type of information that the Federal Reserve may obtain from subsidiaries of bank holding companies in furtherance of its consolidated supervision responsibilities, and on the ability of the Federal Reserve to take action against subsidiaries to address unsafe and unsound practices and enforce compliance with applicable law.

Limiting the Costs of Bank Failures

The timely closing and resolution of failing insured depository institutions is critical to limiting the costs of a failure to the deposit insurance fund.⁷ The conditions governing when the Federal Reserve may close a failing State member bank, however, are significantly more restrictive than those under which the Office of the Comptroller of the Currency may close a national bank, and are even more restrictive than those governing the FDIC’s backup authority to close an insured depository institution after consultation with the appropriate primary Federal and, if applicable, state banking supervisor. The Federal Reserve generally may close a state member bank only for capital-related reasons. The grounds for which the OCC or FDIC may close a bank include a variety of non-capital-related conditions, such as if the institution is facing liquidity pressures that make it likely to be unable to pay its obligations in the normal course of business or if the institution is otherwise in an unsafe or unsound condition to transact business. We hope that the Congress will consider providing the Federal Reserve powers to close a state member bank that are similar to those possessed by other Federal banking agencies.

In view of the number of bank failures that have occurred over the past 18 months and the resulting costs to the deposit insurance fund, policymakers also should explore whether additional triggers—beyond the capital ratios in the current Prompt Corrective Action framework—may be more effective in promoting the timely resolution of troubled institutions at lower cost to the insurance fund. Capital is a lagging indicator of financial difficulties in most instances, and one or more additional measures, perhaps based on asset quality, may be worthy of analysis and consideration.

Conclusion

Thank you for the opportunity to testify on these important matters. We look forward to working with the Congress, the Administration, and the other banking agencies to ensure that the framework for prudential supervision of banking organi-

⁷ Similarly, the creation of a resolution regime that would provide the Government the tools it needs to wind down a systemically important nonbank financial firm in an orderly way and impose losses on shareholders and creditors where possible would help the Government protect the financial system and economy while reducing the potential cost to taxpayers and mitigating moral hazard.

zations and other financial institutions adjusts, as it must, to meet the challenges our dynamic and increasingly interconnected financial system.

PREPARED STATEMENT OF JOHN E. BOWMAN
ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION

AUGUST 4, 2009

I. Introduction

Good morning, Chairman Dodd, Ranking Member Shelby, and Members of the Committee. Thank you for the opportunity to testify today on the Administration's Proposal for Financial Regulatory Reform. It is my pleasure to address the Committee for the first time in my role as Acting Director of the Office of Thrift Supervision (OTS).

We appreciate this Committee's efforts to improve supervision of financial institutions in the United States. We share the Committee's commitment to reforms to prevent any recurrence of our Nation's current financial problems.

We have studied the Administration's Proposal for Financial Regulatory Reform and are pleased to address the questions you have asked us about specific aspects of that Proposal. Specifically, you asked for our opinion of the merits of the Administration's Proposal for a National Bank Supervisor and the elimination of the Federal thrift charter. You also requested our opinion on the elimination of the exceptions in the Bank Holding Company Act for thrifts and certain special purpose banks and about the Federal Reserve System's prudential supervision of holding companies.

II. Goals of Regulatory Restructuring

The recent turmoil in the financial services industry has exposed major regulatory gaps and other significant weaknesses that must be addressed. Our evaluation of the specifics of the Administration's Proposal is predicated on whether or not those elements address the core principles OTS believes are essential to accomplishing true and lasting reform:

1. *Ensure Changes to Financial Regulatory System Address Real Problems*—Proposed changes to financial regulatory agencies should be evaluated based on whether they would address the causes of the economic crisis or other true problems.
2. *Establish Uniform Regulation*—All entities that offer financial products to consumers must be subject to the same consumer protection rules and regulations, so under-regulated entities cannot gain a competitive advantage over their more regulated counterparts. Also, complex derivative products, such as credit default swaps, should be regulated.
3. *Create Ability To Supervise and Resolve Systemically Important Firms*—No provider of financial products should be too big to fail, achieving through size and complexity an implicit Federal Government backing to prevent its collapse—and thereby gaining an unfair advantage over its more vulnerable competitors.
4. *Protect Consumers*—One Federal agency should have as its central mission the regulation of financial products and that agency should establish the rules and standards for all consumer financial products rather than the current, multiple number of agencies with fragmented authority and a lack of singular accountability.

As a general matter the OTS supports all of the fundamental objectives that are at the heart of the Administration's Proposal. By performing an analysis based on these principles, we offer OTS' views on specific provisions of the Administration's Proposal.

III. Administration Proposal To Establish a National Bank Supervisor

We do not support the Administration's Proposal to establish a new agency, the National Bank Supervisor (NBS), by eliminating the Office of the Comptroller of the Currency, which charters and regulates national banks, and the OTS, which charters Federal thrifts and regulates thrifts and their holding companies.

There is little dispute that the *ad hoc* framework of financial services regulation cobbled together over the last century-and-a-half is not ideal. The financial services landscape has changed and the economic crisis has revealed gaps in the system that must be addressed to ensure a sustainable recovery and appropriate oversight in the years ahead. We believe other provisions within the Administration's proposal would assist in accomplishing that goal.

While different parts of the system were created to respond to the needs of the time, the current system has generally served the Nation well over time, despite economic downturns such as the current one. We must ensure that in the rush to address what went wrong, we do not try to “fix” nonexistent problems nor attempt to fix real problems with flawed solutions.

I would like to dispel the two rationales that have been alleged to support the proposal to eliminate the OTS: (1) The OTS was the regulator of the purportedly largest insured depository institutions that failed during the current economic turmoil, and, (2) Financial institutions “shopping” for the most lenient regulator allegedly flocked to OTS supervision and the thrift charter. Both of those allegations are false.

There are four reasons why the first allegation is untrue:

First, failures by insured depository institutions have been no more severe among OTS-regulated thrifts than among institutions supervised by other Federal banking regulators. OTS-regulated Washington Mutual, which failed in September 2008 at no cost to the deposit insurance fund, was the largest bank failure in U.S. history because anything larger has been deemed “too big to fail.” By law, the Federal Government can provide “open-bank assistance” only to prevent a failure. Institutions much larger than Washington Mutual, for example, Citigroup and Bank of America, had collapsed, but the Federal Government prevented their failure by authorizing open bank assistance. The “too big to fail” institutions are not regulated by the OTS. The OTS did not regulate the largest banks that failed; the OTS regulated the largest banks that were allowed to fail.

Second, in terms of numbers of bank failures during the crisis, most banks that have failed have been State-chartered institutions, whose primary Federal regulator is not the OTS.

Third, the OTS regulates financial institutions that historically make mortgages for Americans to buy homes. By law, thrift institutions must keep most of their assets in home mortgages or other retail lending activities. The economic crisis grew out of a sharp downturn in the residential real estate market, including significant and sustained home price depreciation, a protracted decline in home sales and a plunge in rates of real estate investment. To date, this segment of the market has been hardest hit by the crisis and OTS-regulated institutions were particularly affected because their business models focus on this segment.

Fourth, the largest failures among OTS-regulated institutions during this crisis concentrated their mortgage lending in California and Florida, two of the States most damaged by the real estate decline. These States have had significant retraction in the real estate market, including double-digit declines in home prices and record rates of foreclosure.¹ Although today’s hindsight is 20/20, no one predicted during the peak of the boom in 2006 that nationwide home prices would plummet by more than 30 percent.

The argument about regulator shopping, or arbitrage, seems to stem from the conversion of Countrywide, which left the supervision of the OCC and the Board of Governors of the Federal Reserve System (FRB) in March 2007—after the height of the housing and mortgage boom—and came under OTS regulation. Countrywide made most of its high-risk loans through its holding company affiliates before it received a thrift charter.

An often-overlooked fact is that a few months earlier, in October 2006, Citibank converted two thrift charters from OTS supervision to the OCC. Those two Citibank charters totaled more than \$232 billion—more than twice the asset size of Countrywide (\$93 billion)—We strongly believe that Citibank and Countrywide applied to change their charters based on their respective business models and operating strategies. Any suggestion that either company sought to find a more lenient regulatory structure is without merit.

In the last 10 years (1999–2008), there were 45 more institutions that converted away from the thrift charter (164) than converted to the thrift charter (119). Of those that converted to the OTS, more than half were State-chartered thrifts (64). In dollar amounts during the same 10-year period, \$223 billion in assets converted to the thrift charter from other charter types and \$419 billion in assets converted from the thrift charter to other charter types.

We disagree with any suggestion that banks converted to the thrift charter because OTS was a more lenient regulator. Institutions chose the charter type that best fits their business model.

¹See, Office of Thrift Supervision Quarterly Market Monitor, May 7, 2009, (<http://files.ots.treas.gov/131020.pdf>).

If regulatory arbitrage is indeed a major issue, it is an issue between a Federal charter and the charters of the 50 States, as well as among the States. Under the Administration's Proposal, the possibility of such arbitrage would continue.

The OTS is also concerned that the NBS may tend, particularly in times of stress, to focus most of its attention on the largest institutions, leaving midsize and small institutions in the back seat. It is critical that all regulatory agencies be structured and operated in a manner that ensures the appropriate supervision and regulation of all depository institutions, regardless of size.

IV. Administration Proposal To Eliminate the Thrift Charter

The OTS does not support the provision in the Administration's Proposal to eliminate the Federal thrift charter and require all Federal thrift institutions to change their charter to the National Bank Charter or State bank. We believe the business models of Federal banks and thrift institutions are fundamentally different enough to warrant two distinct Federal banking charters.

It is important to note that elimination of the thrift charter would not have prevented the current mortgage meltdown, nor would it help solve current problems or prevent future crises. Savings associations generally are smaller institutions that have strong ties to their communities. Many thrifts never made subprime or Alt-A mortgages; rather they adhered to traditional, solid underwriting standards. Most thrifts did not participate in the private originate-to-sell model; they prudently underwrote mortgages intending to hold the loans in their own portfolios until the loans matured.

Forcing thrifts to convert from thrifts to banks or State chartered savings associations would not only be costly, disruptive, and punitive for thrifts, but could also deprive creditworthy U.S. consumers of the credit they need to become homeowners and the extension of credit this country needs to stimulate the economy.

We also strongly support retaining the mutual form of organization for insured institutions. Generally, mutual institutions are weathering the current financial crisis better than their stock competitors. The distress in the housing markets has had a much greater impact on the earnings of stock thrifts than on mutual thrifts over the past year. For the first quarter 2009, mutual thrills reported a return on average assets (ROA) on 0.42 percent, while stock thrifts reported an ROA of 0.04 percent. We see every reason to preserve the mutual institution charter and no compelling rationale to eliminate it.

OTS also supports retention of the dual banking system with both Federal and State charters for banks and thrifts. This system has served the financial markets in the United States well. The States have provided a charter option for banks and thrifts that have not wanted to have a Federal charter. Banks and thrifts should be able to choose whether to operate with a Federal charter or a State charter.

V. Administration Proposal To Eliminate the Exceptions in the Bank Holding Company Act for Thrifts and Special Purpose Banks

A. Elimination of the Exception in the Bank Holding Company Act for Thrifts

Because a thrill is not considered a "bank" under the Bank Holding Company Act of 1956 (BHCA),² the FRB does not regulate entities that own or control only savings associations. However, the OTS supervises and regulates such entities pursuant to the Home Owners Loan Act (HOLA).

As part of the recommendation to eliminate the Federal thrift charter, the Administration Proposal would also eliminate the savings and loan holding company (SLHC). The Administration's draft legislation repeals section 10 of the HOLA, concerning the regulation of SLHCs and also eliminates the thrift exemption from the definition of "bank" under the BHCA. A SLHC would become a bank holding company (BHC) by operation of law and would be required to register with the FRB as a BHC within 90 days of enactment of the act.

Notably, these provisions also apply to the unitary SLHCs that were explicitly permitted to continue engaging in commercial activities under the Gramm-Leach-Bliley Act of 1999.³ Such an entity would either have to divest itself of the thrift or divest itself of other subsidiaries or affiliates to ensure that its activities are "financial in nature."⁴

The Administration justifies the elimination of SLHCs, by arguing that the separate regulation and supervision of bank and savings and loan holding companies has created "arbitrage opportunities." The Administration contends that the intensity of supervision has been greater for BHCs than SLHCs.

² 12 U.S.C. 1841(c)(2)(B) and (j).

³ 12 U.S.C. 1467a(c)(9)(C).

⁴ 12 U.S.C. 1843(k).

Our view on this matter is guided by our key principles, one of which is to ensure that changes to the financial regulatory system address real problems. We oppose this provision because it does not address a real problem. As is the case with the regulation of thrift institutions, OTS does not believe that entities became SLHCs because OTS was perceived to be a more lenient regulator. Instead, these choices were guided by the business model of the entity.

The suggestion that the OTS does not impose capital requirements on SLHCs is not correct. Although the capital requirements for SLHCs are not contained in OTS regulations, savings and loan holding company capital adequacy is determined on a case-by-case basis for each holding company based on the overall risk profile of the organization. In its review of a SLHCs capital adequacy, the OTS considers the risk inherent in an enterprise's activities and the ability of capital to absorb unanticipated losses, support the level and composition of the parent company's and subsidiaries' debt, and support business plans and strategies.

On average SLHCs hold more capital than BHCs. The OTS conducted an internal study comparing SLHC capital levels to BHC capital levels. In this study, OTS staff developed a Tier 1 leverage proxy and conducted an extensive review of industry capital levels to assess the overall condition of holding companies in the thrift industry. We measured capital by both the Equity/Assets ratio and a Tier 1 Leverage proxy ratio. Based on peer group averages, capital levels (as measured by both the Equity/Assets ratio and a Tier 1 Leverage proxy ratio) at SLHCs were higher than BHCs, prior to the infusion of Troubled Asset Relief Program funds, in every peer group category. The consistency in results between both ratios lends credence to the overall conclusion, despite any differences that might result from use of a proxy formula.

As this study shows, the facts do not support the claim that the OTS does not impose adequate capital requirements on SLHCs. The proposal to eliminate the SLHC exception from the BHCA is based on this and other misperceptions. Moreover, in our view the measure penalizes the SLHCs and thrifts that maintained solid underwriting standards and were not responsible for the current financial crisis. The measure is especially punitive to the unitary SLHCs that will be forced to divest themselves of their thrift or other subsidiaries.

We believe SLHCs should be maintained and that the OTS should continue to regulate SLHCs, except in the case of a SLHC that would be deemed to be a Tier 1 Financial Holding Company. These entities should be regulated by the systemic risk regulator.

B. Elimination of the Exception in the Bank Holding Company Act for Special Purpose Banks

The Administration Proposal would also eliminate the BHCA exceptions for a number of special purpose banks, such as industrial loan companies, credit card banks, trust companies, and the so-called "nonbank banks" grandfathered under the Competitive Equality Banking Act of 1987. Neither the FRB nor OTS regulates the entities that own or control these special purpose banks, unless they also own or control a bank or thrift. As is the case with unitary SLHCs, the Administration Proposal would force these entities to divest themselves of either their special purpose bank or other entities. The Administration's rationale for the provision is to close all the so-called "loopholes" under the BHCA and to treat all entities that own or control any type of a bank equally.

Once again our opinion on this aspect of the Administration Proposal is guided by the key principle of ensuring that changes to the financial regulatory system address real problems that caused the crisis. There are many causes of the financial crisis, but the inability of the FRB to regulate these entities is not one of them. Accordingly, we do not support this provision.

Forcing companies that own special purpose banks to divest one or more of their subsidiaries is unnecessary and punitive. Moreover, it does not address a problem that caused the crisis or weakens the financial system.

VI. Prudential Supervision of Holding Companies

A. In General

The Administration's Proposal would provide for the consolidated supervision and regulation of any systemically important financial firm (Tier 1 FHC) regardless of whether the firm owns an insured depository institution. The authority to supervise and regulate Tier 1 FHCs would be vested in the FRB. The FRB would be authorized to designate Tier 1 FHCs if it determines that material financial distress at the company could pose a threat, globally or in the United States, to financial sta-

bility or the economy during times of economic stress.⁵ The FRB, in consultation with Treasury, would issue rules to guide the identification Tier 1 FHCs. Tier 1 FHCs would be subjected to stricter and more conservative prudential standards than those that apply to other BHCs, including higher standards on capital, liquidity, and risk management. Tier 1 FHCs would also be subject to Prompt Corrective Action.

The Proposal also calls for the creation of a Financial Services Oversight Council (Council) made up of the Secretary of the Treasury and all of the Federal financial regulators. Among other responsibilities, the Council would make recommendations to the FRB concerning institutions that should be designated as Tier 1 FHCs. Also, the FRB would consult the Council in setting material prudential standards for Tier 1 FHCs and in setting risk management standards for systemically important systems and activities regarding payment, clearing and settlement.

The Administration's Proposal provides a regime to resolve Tier 1 FHCs when the stability of the financial system is threatened. The resolution authority would supplement and be modeled on the existing resolution regime for insured depository institutions under the Federal Deposit Insurance Act. The Secretary of the Treasury could invoke the resolution authority only after consulting with the President and upon the written recommendation of two-thirds of the members of the FRB, and the FDIC or SEC as appropriate. The Secretary would have the ability to appoint a receiver or conservator for the failing firm. In general, that role would be filled by the FDIC, though the SEC could be appointed in certain cases. In order to fund this resolution regime, the FDIC would be authorized to impose risk-based assessments on Tier 1 FHCs.

OTS's views on these aspects of the Administration Proposal is guided by our key principle that any financial reform package should create the ability to supervise and resolve all systemically important financial firms. The U.S. economy operates on the principle of healthy competition. Enterprises that are strong, industrious, well-managed and efficient succeed and prosper. Those that fall short of the mark struggle or fail and other, stronger enterprises take their places. Enterprises that become "too big to fail" subvert the system when the Government is forced to prop up failing, systemically important companies in essence, supporting poor performance and creating a "moral hazard."

The OTS supports this aspect of the Proposal and agrees that there is a pressing need for a systemic risk regulator with broad authority to monitor and exercise supervision over any company whose actions or failure could pose unacceptable risk to financial stability. The systemic risk regulator should have the ability and the responsibility for monitoring all data about markets and companies, including, but not limited to, companies involved in banking, securities, and insurance.

We also support the establishment of a strong and effective Council. Each of the financial regulators would provide valuable insight and experience to the systemic risk regulator.

We also strongly support the provision providing a resolution regime for all Tier 1 FHCs. Given the events of recent years, it is essential that the Federal Government have the authority and the resources to act as a conservator or receiver and to provide an orderly resolution of systemically important institutions, whether banks, thrifts, bank holding companies or other financial companies. The authority to resolve a distressed Tier 1 FHC in an orderly manner would ensure that no bank or financial firm is "too big to fail." A lesson learned from recent events is that the failure or unwinding of systemically important companies has a far reaching impact on the economy, not just on financial services.

The continued ability of banks, thrifts, and other entities in the United States to compete in today's global financial services marketplace is critical. The systemic risk regulator should be charged with coordinating the supervision of conglomerates that have international operations. Safety and soundness standards, including capital

⁵ The FRB would be required to base its determination on the following criteria:

- (i) the amount and nature of the company's financial assets;
- (ii) the amount and types of the company's liabilities, including the degree of reliance on short-term funding;
- (iii) the extent of the company's off-balance sheet exposures;
- (iv) the extent of the company's transactions and relationships with other major financial companies;
- (v) the company's importance as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the financial system;
- (vi) the recommendation, if any, of the Financial Services Oversight Council; and
- (vii) any other factors that the Board deems appropriate.

Title II, Section 204. Administration Draft Legislation.

<http://www.financialstability.gov/docs/regulatoryreform/07222009/titleII.pdf>.

adequacy and other factors, should be as comparable as possible for entities that have multinational businesses,

B. Role of the Prudential Supervisor in Relation to the Systemic Risk Regulator

You have asked for our views on what we consider to be the appropriate role of the prudential supervisor in relation to the systemic risk regulator. In other words, what is the proper delineation of responsibilities between the agencies?

Generally, we believe that for systemically important institutions, the systemic risk regulator should supplement, not supplant, the primary Federal bank supervisor. In most cases the work of the systemic regulator and the prudential regulator will complement one another, with the prudential regulator focused on the safety and soundness of the depository institution and the systemic regulator focused more broadly on financial stability globally or in the United States.

One provision in the Proposal provides the systemic risk regulator with authority to establish, examine, and enforce more stringent standards for subsidiaries of Tier 1 FHCs—including depository institution subsidiaries—to mitigate systemic risk posed by those subsidiaries. If the systemic risk regulator issues a regulation, it must consult with the prudential regulator. In the case of an order, the systemic regulator must: (1) have reasonable cause to believe that the functionally regulated subsidiary is engaged in conduct, activities, transactions, or arrangements that could pose a threat to financial stability or the economy globally or in the United States; (2) notify the prudential regulator of its belief, in writing, with supporting documentation included and with a recommendation that the prudential regulator take supervisory action against the subsidiary; and (3) not been notified in writing by the prudential regulator of the commencement of a supervisory action, as recommended, within 30 days of the notification by the systemic regulator.

We have some concerns with this provision in that it supplants the prudential regulator's authority over depository institution subsidiaries of systemically significant companies. On balance, however, we believe such a provision is necessary to ensure financial stability. We recommend that the provision include a requirement that before making any determination, the systemic regulator consider the effects of any contemplated action on the Deposit Insurance Fund and the United States taxpayers.

C. Regulation of Thrifts and Holding Companies on a Consolidated Basis

You have asked for OTS's views on whether a holding company regulator should be distinct from the prudential regulator or whether a consolidated prudential bank supervisor could also regulate holding companies.⁶

The OTS supervises both thrifts and their holding companies on a consolidated basis. Indeed, SLHC supervision is an integral part of OTS oversight of the thrift industry. OTS conducts holding company examinations concurrently with the examination of the thrift subsidiary, supplemented by offsite monitoring. For the most complex holding companies, OTS utilizes a continuous supervision approach. We believe the regulation of the thrift and holding company has enabled us to effectively assess the risks of the consolidated entity, while retaining a strong focus on protecting the Deposit Insurance Fund.

The OTS has a wealth of expertise regulating thrifts and holding companies. We have a keen understanding of small, medium-sized and mutual thrifts and their holding companies. We are concerned that if the FRB became the regulator of these holding companies, it would focus most of its attention on the largest holding companies to the detriment of small and mutual SLHCs.

With regard to holding company regulation, OTS believes thrifts that have non-systemic holding companies should have strong, consistent supervision by a single regulator. Conversely, a SLHC that would be deemed to be a Tier 1 FHC should be regulated by the systemic regulator. This is consistent with our key principle that any financial reform package should create the ability to supervise and resolve all systemically important financial firms.

VII. Consumer Protection

The Committee did not specifically request input regarding consumer protection issues and the Administration's Proposal to create a Consumer Financial Protection Agency (CFPA); however, we would like to express our views because adequate protection of consumers is one of the key principles that must be addressed by effective reform. Consumer protection performed consistently and judiciously fosters a thriving banking system to meet the financial services needs of the Nation.

⁶With respect to this question we express our opinion only concerning thrifts and their holding companies. We express no opinion as to banks and BHCs.

The OTS supports the creation of a CFPA that would consolidate rulemaking authority over all consumer protection regulations in one regulator. The CFPA should be responsible for promulgating all consumer protection regulations that would apply uniformly to all entities that offer financial products, whether a federally insured depository institution, a State bank, or a State-licensed mortgage broker or mortgage company. Making all entities subject to the same rules and regulations for consumer protection could go a long way towards accomplishing OTS's often stated goal of plugging the gaps in regulatory oversight that led to a shadow banking system that was a significant cause of the current crisis.

Although we support the concept of a single agency to write all consumer rules, we strongly believe that consumer protection-related examinations, supervision authority and enforcement powers for insured depository institutions should be retained by the FBAs and the National Credit Union Administration (NCUA). In addition to rulemaking authority, the CFPA should have regulation, examination and enforcement power over entities engaged in consumer lending that are not insured depository institutions. Regardless of whether a new consumer protection agency is created, it is critical that, for all federally insured depository institutions, the primary Federal safety and soundness regulator retain authority for regulation, examination, and enforcement of consumer protection regulations.

VIII. Conclusion

In conclusion, we support the goals of the Administration and this Committee to create a reformed system of financial regulation that fills regulatory gaps and prevents the type of financial crisis that we have just endured.

Thank you again, Mr. Chairman, Ranking Member Shelby, and Members of the Committee for the opportunity to testify on behalf of the OTS.

We look forward to working with the Members of this Committee and others to create a system of financial services regulation that promotes greater economic stability for providers of financial services and the Nation.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING
FROM SHEILA C. BAIR**

Q.1. What is the best way to decrease concentration in the banking industry? Is it size limitations, rolling back State preemption, higher capital requirements, or something else?

A.1. We must find ways to impose greater market discipline on systemically important institutions. We believe there are several ways to decrease concentration levels in the banking industry without the Federal Government setting size limits on banks. For example, certain requirements, such as higher capital and liquidity levels, could be established to mirror the heightened risk they pose to the financial system. Assessments also could be used as incentives to contain growth and complexity, as well as to limit concentrations of risk and risk taking.

However, one of the lessons of the past few years is that regulation alone is not enough to control imprudent risk taking within our dynamic and complex financial system. You need robust and credible mechanisms to ensure that market players will actively monitor and keep a handle on risk taking. In short, we need to enforce market discipline for systemically important institutions. To end “too big to fail,” we need an orderly and highly credible mechanism that is similar to the process we use to resolve FDIC-insured banks. In such a process, losses would be borne by the stockholders and bondholders of a holding company, and senior managers would be replaced. There would be an orderly resolution of the institution, but no bail-out. Open bank assistance should not be used to prop up any individual firm.

Q.2. Treasury has proposed making the new banking regulator a bureau of the Treasury Department. Putting aside whether we should merge the current regulators, does placing the new regulator in Treasury rather than as a separate agency provide enough independence from political influence?

A.2. We believe independence is an essential element of a sound supervisory program. Supervisors must have the authority and resources to gather and evaluate sufficient information to make sound supervisory decisions without undue pressures from outside influences. The FDIC and State banking supervisors, who often provide a different and unique perspective on the operations of community banks, have worked cooperatively to make sound supervisory decisions without compromising their independence.

As currently structured, two of the Federal banking agencies, the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) are bureaus within the U.S. Department of the Treasury. Although subject to general Treasury oversight, the OCC and OTS have a considerable amount of autonomy within the Treasury with regard to examination and enforcement matters. Unlike Treasury, the bureaus within the U.S. Department of OCC and OTS are funded by examination and other fees assessed on regulated entities, and they have independent litigating authority. The other three Federal banking agencies—Governors of the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve, and the National Credit Union Association, are fully independent agencies, self-funded though assessments or

other fees, and have independent litigating authority. To the extent the OTS and OCC would be merged into a single regulator under Treasury, continued independence could be maintained through nonappropriated funding sources, independent litigating authority, and independent decision-making authority, such as currently afforded to the OCC and OTS.

Q.3. Given the damage caused by widespread use of subprime and nontraditional mortgages—particularly low documentation mortgages—it seems that products that are harmful to the consumer are also harmful to the banks that sell them. If bank regulators do their job and stop banks from selling products that are dangerous to the banks themselves, other than to set standards for currently unregulated firms, why do we need a separate consumer protection agency?

A.3. As currently proposed, the new Consumer Financial Protection Agency (CFPA) would be given sole rulemaking authority for consumer financial protection statutes over all providers of consumer credit, including those outside the banking industry. The CFPA would set a floor on consumer regulation and guarantee the States' ability to adopt and enforce stricter (more protective) laws for institutions of all types, regardless of charter. It also is proposed that the CFPA would have consumer protection examination and enforcement authority over all providers of consumer credit and other consumer products and services—banks and nonbanks.

Giving the CFPA the regulatory and supervisory authority over nonbanks would fill in the existing regulatory and supervisory gaps between nonbanks and insured depository institutions and is key to addressing most of the abusive lending practices that occurred institutions and is key to addressing most of during the current crisis. In addition, the provision to give the CFPA sole rulewriting authority over consumer financial products and services would establish strong, consistent consumer protection standards among all providers of financial products and services and eliminate potential regulatory arbitrage that exists because of Federal preemption of certain State laws.

However, the Treasury proposal could be made even more effective with a few targeted changes. As recent experience has shown, consumer protection issues and the safety and soundness of insured institutions go hand-in-hand and require a comprehensive, coordinated approach for effective examination and supervision. Separating Federal banking agency examination and supervision (including enforcement) from consumer protection examination and supervision could undermine the effectiveness of each with the unintended consequence of weakening bank oversight.

As a Federal banking supervisor and the ultimate insurer of \$6 trillion in deposits, the FDIC has the responsibility and the need to ensure consumer protection and safety and soundness are properly integrated. The FDIC and other Federal banking agencies should retain their authority to examine and supervise insured depository institutions for consumer protection standards established by the CFPA. The CFPA should focus its examination and enforcement resources on nonbank providers of products and services that have not been previously subject to Federal examinations and

standards. The CFPA also should have back-up examination and enforcement authority to address situations where it determines the Federal banking agency supervision is deficient.

Q.4. Since the two most recent banking meltdowns were caused by mortgage lending, do you think it is wise to have a charter focused on mortgage lending? In other words, why should we have a thrift charter?

A.4. Over several decades, financial institutions with thrift charters have provided financing for home loans for many Americans. In recent years, Federal and State banking charters have expanded into more diversified, full service banking operations that include commercial and residential mortgage lending. However, it is understandable that the lack of diversification and exposure to the housing market could raise concerns about the thrift charter. Market forces have reduced the demand for thrift charters. Given the dwindling size of the Federal thrift industry, it makes sense to consider merging the Federal thrift charter into a single Federal depository institution charter.

Q.5. Should banking regulators continue to be funded by fees on the regulated firms, or is there a better way?

A.5. We believe the banking industry should pay for its supervision, but the Federal bank supervision funding process should not disadvantage State-chartered depository institutions and the dual banking system. State-chartered banks pay examination fees to State banking agencies. The Federal banking agencies are self-funded through assessments, exam fees, and other sources. This arrangement helps them remain independent of the political process and separates them from the Federal budget appropriations.

Q.6. Why should we have a different regulator for holding companies than for the banks themselves?

A.6. We do not believe it is always necessary to have a different regulator for the holding company and the bank. Numerous one-bank holding companies exist where the bank is essentially the only asset owned by the holding company. In these cases, there is no reason why bank regulators could not also serve as holding company regulators as it is generally more efficient and prudent for one regulator to evaluate both entities.

In the case of more complex multibank holding companies, one can argue it is more effective for the primary Federal regulators to examine the insured depository institutions while the Federal Reserve evaluates the parent (as a source of strength) and the financial condition of the nonbank subsidiaries. Yet even for a separate holding company regulator, the prudential standards it applies should be at least as strong as the standards applied to insured banks.

Q.7. Assuming we keep thrifts and thrift holding companies, should thrift holding companies be regulated by the same regulator as bank holding companies?

A.7. Similar to the answer to Question 6, it may not be necessary for small thrifts that are owned by what are essentially shell holding companies to have a separate holding company regulator. While one can argue that more complex organizations merit a separate

holding company regulator, even in this structure we believe prudential standards applied to a holding company should be at least as strong as those applied to an insured entity.

Q.8. The proposed risk council is separate from the normal safety and soundness regulator of banks and other firms. The idea is that the council will set rules that the other regulators will enforce. That sounds a lot like the current system we have today, where different regulators read and enforce the same rules different ways. Under such a council, how would you make sure the rules were being enforced the same across the board?

A.8. The proposed risk council would oversee systemic risk issues, develop needed prudential policies, and mitigate developing systemic risks. A primary responsibility of the council should be to harmonize prudential regulatory standards for financial institutions, products, and practices to assure market participants cannot arbitrage regulatory standards in ways that pose systemic risk. The council should evaluate different capital standards that apply to commercial banks, investment banks, investment funds, and others to determine the extent to which these standards circumvent regulatory efforts to contain excess leverage in the system. The council should ensure that prompt corrective action and capital standards are harmonized across firms. For example, large financial holding companies should be subject to tougher prompt corrective action standards under U.S. law and be subject to holding company capital requirements that are no less stringent than those for insured banks. The council also should undertake the harmonization of capital and margin requirements applicable to all OTC derivatives activities and facilitate interagency efforts to encourage greater standardization and transparency of derivatives activities and the migration of these activities onto exchanges or central counterparties. To be successful, the council must have sufficient authority to require some uniformity and standardization in those areas where appropriate.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM JOHN C. DUGAN

Q.1. What is the best way to decrease concentration in the banking industry? Is it size limitations, rolling back State preemption, higher capital requirements, or something else?

A.1. The financial crisis has highlighted the importance of interlinkages between the performance of systemically important banks, financial stability, and the real economy. It has also highlighted the risks of firms that are deemed “too big to fail.” There are a range of policy options that are under active consideration by U.S. and global supervisors to address these issues. Given the multifaceted nature of this problem, we believe that a combination of policy responses may be most appropriate.

A crucial first step, we believe, is strengthening and raising the current capital standards for large banking organizations to ensure that these organizations maintain sufficient capital for the risks they take and pose to the financial system. Part of this effort is well underway through initiatives being taken by the Basel Com-

mittee on Bank Supervision (the “Committee”). As announced in July, the Committee has adopted a final package of measures that will strengthen and increase the capital required for trading book and certain securitization structures. The results of a recent quantitative analysis conducted by the Committee to assess the impact of the trading book rule changes suggest that these changes will increase average trading book capital requirements by two to three times their current levels, although the Committee noted significant dispersion around this average.

The Committee has underway several other key initiatives that we believe are also critical to reduce the risks posed by large, internationally active banks. These include:

- Strengthening the quality, international consistency, and transparency of a bank’s capital base;
- Developing a uniform Pillar -1 based leverage ratio, which, among other requirements, would apply a 100 percent credit conversion factor to certain off-balance sheet credit exposures;
- Introducing a minimum global standard for funding liquidity that includes a stressed liquidity coverage ratio requirement, underpinned by a longer-term structural liquidity ratio; and
- Developing a framework for countercyclical capital buffers above the minimum requirement. The framework will include capital conservation measures such as constraints on capital distributions. The Basel Committee will review an appropriate set of indicators, such as earnings and credit-based variables, as a way to condition the build up and release of capital buffers. In addition, the Committee will promote more forward-looking provisions based on expected losses.

The OCC has been actively involved in, and strongly supports, these initiatives. In addition to these actions, there are other policy initiatives under consideration, including the development of incremental capital surcharges that would increase with the size and/or risk of the institution, and measures to reduce the systemic impact of failure, such as reduced interconnectedness and resolution planning.

As noted in my testimony, the OCC also endorses domestic proposals to establish a Financial Stability Oversight Council that would identify and monitor systemic risk, gather and share systemically significant information, and make recommendations to individual regulators. This council would consist of the Secretary of the Treasury and all of the Federal financial regulators, and would be supported by a permanent staff. We also endorse enhanced authority to resolve systemically significant financial firms.

We believe that a multipronged approach, as outlined above; is far more appropriate than relying on a single measure, such as asset size, to address the risks posed by large institutions. We also believe that to ensure the competitiveness of U.S. financial institutions in today’s global economy, many of these policy initiatives need to be coordinated with, and implemented by, supervisors across the globe.

Finally, we strongly disagree with any suggestion that Federal preemption was a root cause of the financial crisis or that rolling back preemption would be a solution. In this regard, we would

highlight that the systemic risk posed by companies such as AIG, Lehman Brothers, and Bear Stearns were outside of the OCC's regulatory authority and thus not affected by the OCC's application of Federal preemption decisions.

Q.2. Treasury has proposed making the new banking regulator a bureau of the Treasury Department. Putting aside whether we should merge the current regulators, does placing the new regulator in Treasury rather than as a separate agency provide enough independence from political influence?

A.2. It is critical that the new agency be independent from the Treasury Department and the Administration to the same extent that the OCC and OTS are currently independent. For example, current law provides the OCC with important independence from political interference in decision making in matters before the Comptroller, including enforcement proceedings; provides for funding independent of political control; enables the OCC to propose and promulgate regulations without approval by the Treasury; and permits the agency to testify before Congress without the need for the Administration's clearance of the agency's statements. It is crucial that these firewalls be maintained in a form that is at least as robust as current law provides with respect to the OCC and the OTS, to enable the new regulator to maintain comparable independence from political influence. In addition, consideration should be given to providing the new regulator the same independence from OMB review and clearance of its regulations as is currently provided for the FDIC and the Federal Reserve Board. This would further protect the new agency's rulemaking process from political interference.

Q.3. Given the damage caused by widespread use of subprime and nontraditional mortgages—particularly low documentation mortgages—it seems that products that are harmful to the consumer are also harmful to the banks that sell them. If bank regulators do their job and stop banks from selling products that are dangerous to the banks themselves, other than to set standards for currently unregulated firms, why do we need a separate consumer protection agency?

A.3. In the ongoing debate about reforming the structure of financial services regulation to address the problems highlighted by the financial crisis, relatively little attention has been paid to the initial problem that sparked the crisis: the exceptionally weak, and ultimately disastrous, mortgage underwriting practices accepted by lenders and investors. The worst of these practices included:

- The failure to verify borrower representations about income and financial assets (the low documentation loans mentioned in this question);
- The failure to require meaningful borrower equity in the form of real down payments;
- The acceptance of very high debt-to-income ratios;
- The qualification of borrowers based on their ability to afford artificially low initial monthly payments rather than the much higher monthly payments that would come later; and

- The reliance on future house price appreciation as the primary source of repayment, either through refinancing or sale.

The consequences of these practices were disastrous not just for borrowers and financial institutions in the United States, but also for investors all over the world due to the transmission mechanism of securitization. To prevent this from happening again, while still providing adequate mortgage credit to borrowers, regulators need to establish, with additional legislative authorization as necessary, at least three minimum underwriting standards for all home mortgages:

- First, underwriters should verify income and assets.
- Second, borrowers should be required to make meaningful down payments.
- Third, a borrower should not be eligible for a mortgage where monthly payments increase over time unless the borrower can afford the later, high payments.

It is critical that these requirements, and any new mortgage regulation that is adopted, apply to all credit providers to prevent the kind of competitive inequity and pressure on regulated lenders that eroded safe and sound lending practices in the past. Prudential bank supervisors, including the OCC, are best positioned to develop such new underwriting standards and would enforce them vigorously with respect to the banks they supervise. A separate regulatory mechanism would be required to ensure that such standards are implemented by nonbanks. While the proposed new Consumer Financial Protection Agency would have consumer protection regulatory authority with respect to nonbanks, they would not have—and they should not have—safety and soundness regulatory authority over underwriting standards.

Q.4. Since the two most recent banking meltdowns were caused by mortgage lending, do you think it is wise to have a charter focused on mortgage lending? In other words, why should we have a thrift charter?

A.4. When there are systemwide problems with residential mortgages, institutions that concentrate their activities in those instruments will sustain more losses and pose more risk to the deposit insurance fund than more diversified institutions. On the other hand, there are many thrifts that maintained conservative underwriting standards and have weathered the current crisis. The Treasury proposal would eliminate the Federal thrift charter—but not the State thrift charter—with all Federal thrifts required to convert to a national bank, State bank, or State thrift, over the course of a reasonable transition period. (State thrifts would then be treated as State “banks” under Federal law.) An alternative approach would be to preserve the Federal thrift charter, with Federal thrift regulation being conducted by a division of the merged agency. With the same deposit insurance fund, same prudential regulator, same holding company regulator, and a narrower charter (a national bank has all the powers of a Federal thrift plus many others), it is unclear whether institutions will choose to retain their thrift charters over the long term.

Q.5. Should banking regulators continue to be funded by fees on the regulated firms, or is there a better way?

A.5. Funding bank regulation and supervision through fees imposed on the regulated firms is preferable to the alternative of providing funding through the appropriations process because it ensures the independence from political control that is essential to bank supervision.

For this reason, fee-based funding is the norm in banking regulation. In the case of the OCC and OTS, Congress has determined that assessments and fees on national banks and thrifts, respectively, will fund supervisory activities, rather than appropriations from the United States Treasury. Since enactment of the National Bank Act in 1864, the OCC has been funded by various types of fees imposed on national banks, and over the more than 145 years that the OCC has regulated national banks, this funding mechanism has never caused the OCC to weaken or change its regulation or supervision of national banks, including with respect to national banks' compliance with consumer protection laws. Neither the Federal Reserve Board nor the FDIC receives appropriations. State banking regulators typically also are funded by assessments on the entities they charter and supervise.

Q.6. Why should we have a different regulator for holding companies than for the banks themselves?

A.6. Combining the responsibilities for prudential bank supervision and holding company supervision in the same regulator would be a workable approach in the case of those holding companies whose business is comprised solely or overwhelmingly of one or more subsidiary banks. Elimination of a separate holding company regulator in these situations would remove duplication, promote simplicity and accountability, and reduce unnecessary compliance burden for institutions as well.

Such a consolidated approach would be more challenging where the holding company has substantial nonbanking activities in other subsidiaries, such as complex capital markets activities, securities, and insurance. The focus of a dedicated, strong prudential banking supervisor could be significantly diluted by extending its focus to substantial nonbanking activities. The Federal Reserve has unique resources and expertise to bring to bear on supervision of these sorts of activities conducted by bank affiliates in a large, complex holding company. Therefore, a preferable approach would be to preserve such a role for the Federal Reserve Board, but to clearly delineate the respective roles of the Board and the prudential bank supervisors with respect to the holding company's activities.

Q.7. Assuming we keep thrifts and thrift holding companies, should thrift holding companies be regulated by the same regulator as bank holding companies?

A.7. Yes. Thrift holding companies, unlike bank holding companies, currently are not subject to consolidated regulation; for example, no consolidated capital requirements apply at the holding company level. This difference between bank and thrift holding company regulation created arbitrage opportunities for companies that were able to take on greater risk under a less rigorous regulatory regime. Yet, as we have seen—AIG is the obvious example—large

nonbank firms can present similar risks to the system as large banks. This regulatory gap should be closed, and these firms should be subject to the same type of oversight as bank holding companies. The Treasury Proposal would make these types of firms subject to the Bank Holding Company Act and supervision by the Federal Reserve Board. We support this approach, including a reasonable approach to grandfathering the activities of some thrift holding companies that may not conform to the activities limitations of the Bank Holding Company Act.

Q.8. The proposed risk council is separate from the normal safety and soundness regulator of banks and other firms. The idea is that the council will set the rules that the other regulators will enforce. That sounds a lot like the current system we have today, where different regulators read and enforce the same rules different ways. Under such a council, how would you make sure the rules were being enforced the same across the board?

A.8. The Treasury proposal establishes the Financial Services Oversight Council to identify potential threats to the stability of the U.S. financial system; to make recommendations to enhance the stability of the U.S. financial markets; and to provide a forum for discussion and analysis of emerging issues. Based on its monitoring of the U.S. financial services marketplace, the Council would also play an advisory role, making recommendations to, and consulting with, the Board of Governors of the Federal Reserve System. As I understand the Treasury proposal, however, the Council's role is only advisory; it will not be setting any rules. Therefore, we do not anticipate any conflicting enforcement issues to arise from the Council's role.

Q.9. Mr. Dugan, in Mr. Bowman's statement he says Countrywide converted to a thrift from a national bank after it had written most of the worst loans during the housing bubble. That means Countrywide's problems were created under your watch, not his. How do you defend that charge and why should we believe your agency will be able to spot bad lending practices in the future?

A.9. In evaluating the Countrywide situation, it is important to know all the facts. Both Countrywide Bank, N.A., and its finance company affiliate, Countrywide Home Loans, engaged in mortgage lending activities. While the national bank was subject to the supervision of the OCC, Countrywide Home Loans, as a bank holding company subsidiary, was subject to regulation by the Federal Reserve and the States in which it did business.

Mortgage banking loan production occurred predominately at Countrywide Home Loans,¹ the holding company's finance subsidiary, which was not subject to OCC oversight. Indeed, all subprime lending, as defined by the borrower's FICO score, was conducted at Countrywide Home Loans and not subject to OCC oversight. The OCC simply did not allow Countrywide Bank, N.A., to engage in such subprime lending.

When Countrywide Financial Corporation, the holding company, began to transition more of the mortgage lending business from Countrywide Home Loans to the national bank, the OCC started

¹ Countrywide Financial Corporation 10-Q (Mar. 31, 2008).

to raise a variety of supervisory concerns about the bank's lending risk and control practices. Shortly thereafter, on December 6, 2006, Countrywide Bank applied to convert to a Federal savings bank charter.

Countrywide Bank became a Federal savings bank on March 12, 2007. Going forward, Countrywide Bank, FSB, was regulated by OTS, and Countrywide Home Loans was regulated by the OTS and the States in which it did business. Countrywide Financial Corporation continued to transition its mortgage loan production to the Countrywide Bank, FSB. By the end of the first quarter of 2008, over 96 percent of mortgage loan production of Countrywide Financial Corporation occurred at Countrywide Bank, FSB.²

Bank of America completed its acquisition of Countrywide Financial Corporation on June 30, 2008.

Countrywide Bank, N.A., was not the source of toxic subprime loans. The OCC raised concerns when Countrywide began transitioning more of its mortgage lending operations to its national bank charter. It was at that point that Countrywide flipped its national bank charter to a Federal thrift charter. The facts do not imply lax supervision by the OCC, but rather quite the opposite.

The OCC continues to identify and warn about potentially risky lending practices. On other occasions, the OCC has taken enforcement actions and issued guidance to curtail abuses with subprime credit cards and payday loans. Likewise, the Federal banking agencies issued guidance to address emerging compliance risks with nontraditional mortgages, such as payment option ARMs, and the OCC took strong measures to ensure that that guidance was effectively implemented by national banks throughout the country.

Q.10. All of the largest financial institutions have international ties, and money can flow across borders easily. AIG is probably the best known example of how problems can cross borders. How do we deal with the risks created in our country by actions somewhere else, as well as the impact of actions in the U.S. on foreign firms?

A.10. As noted in our response to Question 1, the global nature of today's financial institutions increasingly requires that supervisory policies and actions be coordinated and implemented on a global basis. The OCC is an active participant in various international supervisory groups whose goal is to coordinate supervisory policy responses, to share information, and to coordinate supervisory activities at individual institutions whose activities span national borders. These groups include the Basel Committee on Bank Supervision (BCBS), the Joint Forum, the Senior Supervisors Group (SSG), and the Financial Stability Board. In addition to coordinating capital and other supervisory standards, these groups promote information sharing across regulators.

For example, the SSG recently released a report that evaluates how weaknesses in risk management and internal controls contributed to industry distress during the financial crisis. The observations and conclusions in the report reflect the results of two initiatives undertaken by the SSG. These initiatives involved a series of interviews with firms about funding and liquidity challenges and

² Countrywide Financial Corporation 10-Q (Mar. 31, 2008).

a self-assessment exercise in which firms were asked to benchmark their risk management practices against recommendations and observations taken from industry and supervisory studies published in 2008.

One of the challenges that arise in resolving a cross-border bank crisis is that crisis resolution frameworks are largely designed to deal with domestic failures and to minimize the losses incurred by domestic stakeholders. As such, the current frameworks are not well suited to dealing with serious cross-border problems. In addition to the fact that legal systems and the fiscal responsibility are national matters, a basic reason for the predominance of the territorial approach in resolving banking crises and insolvencies is the absence of a multinational framework for sharing the fiscal burdens for such crises or insolvencies.

To help address these issues, the BCBS has established a Cross-border Bank Resolution Group to compare the national policies, legal frameworks and the allocation of responsibilities for the resolution of banks with significant cross-border operations. On September 17, 2009, the BCBS issued for comment a report prepared by this work group that sets out 10 recommendations that reflect the lessons from the recent financial crisis and are designed to improve the resolution of a failing financial institution that has cross-border activities. The report's recommendations fall into three categories including:

- The strengthening of national resolution powers and their cross-border implementation;
- *Ex ante* action and institution-specific contingency planning, which involves the institutions themselves as well as critical home and host jurisdictions; and,
- Reducing contagion and limiting the impact on the market of the failure of a financial firm by actions such as further strengthening of netting arrangements.

We believe adoption of these recommendations will enhance supervisors' ability to deal with many of the issues posed by resolving a cross-border bank.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM DANIEL K. TARULLO

Q.1. What is the best way to decrease concentration in the banking industry? Is it size limitations, rolling back State preemption, higher capital requirements, or something else?

A.1. Answer not received by time of publication.

Q.2. Treasury has proposed making the new banking regulator a bureau of the Treasury Department. Putting aside whether we should merge the current regulators, does placing the new regulator in Treasury rather than as a separate agency provide enough independence from political influence?

A.2. Answer not received by time of publication.

Q.3. Given the damage caused by widespread use of subprime and nontraditional mortgages—particularly low documentation mortgages—it seems that products that are harmful to the consumer

are also harmful to the banks that sell them. If bank regulators do their job and stop banks from selling products that are dangerous to the banks themselves, other than to set standards for currently unregulated firms, why do we need a separate consumer protection agency?

A.3. Answer not received by time of publication.

Q.4. Since the two most recent banking meltdowns were caused by mortgage lending, do you think it is wise to have a charter focused on mortgage lending? In other words, why should we have a thrift charter?

A.4. Answer not received by time of publication.

Q.5. Should banking regulators continue to be funded by fees on the regulated firms, or is there a better way?

A.5. Answer not received by time of publication.

Q.6. Why should we have a different regulator for holding companies than for the banks themselves?

A.6. Answer not received by time of publication.

Q.7. Assuming we keep thrifts and thrift holding companies, should thrift holding companies be regulated by the same regulator as bank holding companies?

A.7. Answer not received by time of publication.

Q.8. The proposed risk council is separate from the normal safety and soundness regulator of banks and other firms. The idea is that the council will set rules that the other regulators will enforce. That sounds a lot like the current system we have today, where different regulators read and enforce the same rules different ways. Under such a council, how would you make sure the rules were being enforced the same across the board?

A.8. Answer not received by time of publication.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM JOHN E. BOWMAN

Q.1. What is the best way to decrease concentration in the banking industry? Is it size limitations, rolling back State preemption, higher capital requirements, or something else?

A.1. There are several ways to decrease the concentration in the banking industry, including:

1. *Restricting further increases in concentrations.* The largest banks in the U.S. have principally achieved their concentration dominance by mergers and acquisitions. Hence, slight changes to the current rules regarding the regulatory review and approval of mergers/acquisitions could play a large part in restricting further concentration. There could be modest changes made to the Herfindahl Hirschman Index (HHI) analysis when reviewing merger/acquisition applications of very large banks to restrict increases in concentrations.
2. *Reduce current concentrations.* Options could range from severe, such as forced break-ups, to less severe such as requir-

ing largest banks to increase their regulatory capital and/or tangible capital levels.

3. *Reduce the advantages of "Too Big To Fail" (TBTF).* Having the U.S. Government as an implicit backstop for liquidity and capital reserves allowed the largest banks to raise capital at less expensive rates than could smaller, community banks. Large banks were able to use that capital to fund the acquisition of other banks. Removing the U.S. Government as a backstop by implementing explicit take over authority and procedures for TBTF institutions would help eliminate this moral hazard.
4. *Improve the outlook for community banks and thrifts.* Efforts to make it easier to organize new or *de novo* banks and thrifts, as well as for smaller institutions to increase capital levels, would help level the playing field between community institutions and large banks.

Q.2. Treasury has proposed making the new banking regulator a bureau of the Treasury Department. Putting aside whether we should merge the current regulators, does placing the new regulator in Treasury rather than as a separate agency provide enough independence from political influence?

A.2. OTS has stated publicly that it does not support the elimination of the thrift charter or the Administration's Proposal to establish a new agency, the National Bank Supervisor (NBS), by eliminating the Office of the Comptroller of the Currency, which charters and regulates national banks, and the OTS, which charters Federal thrifts and regulates thrifts and their holding companies. However, if a new NBS is established to be the Federal chartering and supervisory authority for Federal depository institutions, such new agency should be independent from the Department of Treasury rather than bureau of the Department.

Among the Federal banking agencies, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation each are independent from Treasury for all purposes. A similar separation for any new banking regulator would assure that the agency would be free from any possible constraints on rulemaking, enforcement, or litigation matters. An example of recently established agency that is independent of the Department of Treasury or any other Department is the Federal Housing Finance Agency, which was created by the Housing and Economic Recovery Act in July 2008.

To the extent that it is determined that the new NBS should be part of the Department of Treasury, if it is granted explicit independence in a number of areas, it would be insulated from political influence to the same degree that the OTS currently is. Examples of the type of activities of the new supervisor that must remain independent include the ability of the agency to testify and to make legislative recommendations. Another important area of independence is the agency's authority to litigate. The current OTS authority provides that Secretary of Treasury may not intervene in any matter or proceeding before OTS, including enforcement matters, and not prevent the issuance of any rule or regulation by the agency. Any new agency should have the same authority that OTS cur-

rently does. The operations of the NBS should be funded by assessments and not through the appropriations process.

Q.3. Given the damage caused by widespread use of subprime and nontraditional mortgages particularly low documentation mortgages—it seems that products that are harmful to the consumer are also harmful to the banks that sell them. If bank regulators do their job and stop banks from selling products that are dangerous to the banks themselves, other than to set standards for currently unregulated firms, why we need a separate consumer protection agency?

A.3. The OTS examines institutions to ensure that they are operating in a safe and sound manner. OTS does not believe that Federal regulators should dictate the types of products that lenders must offer. Although we believe strongly that Government regulators should prohibit products or practices that are unfair to consumers, the Government should not be overly prescriptive in defining lenders' business plans or mandating that certain products be offered to consumers.

Defining standards for financial products would put a Government seal of approval on certain favored products and would effectively steer lenders toward products. It could have the unintended consequence of fewer choices for consumers by stifling innovation and inhibiting the creation of products that could benefit consumers and financial institutions. We are concerned about the consumer protection agency defining standards for financial products and services that would require institutions to offer certain products (*e.g.*, 30-year fixed rate mortgages). The imposition of such a requirement could result in safety and soundness concerns and stifle credit availability and innovation.

The OTS supports consolidating rulemaking authority over all consumer protection regulation in one Federal regulator such as the proposed consumer protection agency. This regulator should be responsible for promulgating all consumer protection regulations that would apply uniformly to all entities that offer financial products, whether an insured depository institution, State-licensed mortgage broker or mortgage company. Any new framework should be to ensure that similar bank or bank-like products, services, and activities are treated in the same way in a regulation, whether they are offered by a chartered depository institution, or an unregulated financial services provider. The product should receive the same review, oversight, and scrutiny regardless of the entity offering the product.

To balance the safety and soundness requirements of depository institutions with these important functions of the consumer protection agency, the OTS recommends retaining primary consumer-protection-related examination and supervision authority for insured depository institutions with the FBAs and the NCUA. The OTS believes that the CFPA should have primary examination and enforcement power over entities engaged in consumer lending that are not under the jurisdiction of the FBAs.

Safety and soundness and consumer protection examination and enforcement powers should not be separated for insured depository institutions because safety-and-soundness examinations com-

plement and strengthen consumer protection. By separating safety-and-soundness functions from consumer protection, the CFPA and an FBA could each have gaps in their information concerning an institution.

Q.4. Since the two most recent banking meltdowns were caused by mortgage lending, do you think it is wise to have a charter focused on mortgage lending? In other words, why should we have a thrift charter?

A.4. Beginning with the enactment of the Home Owners Loan Act, Congress has several times acted to reinforce a national housing policy. Over the years, Congress has taken steps to ensure that a specialized housing lender is retained among the charter options available for insured institutions. The causes of any banking crisis are difficult to identify because of the interconnected nature of financial services. The crisis that we currently are working through is different in several important ways from the banking crisis of the 1980s and early 1990s. In the early months of the current crisis, there appeared to be similarities in its origins to the crisis of the 1980s and appeared to have been caused by mortgage lending. Even if the early obvious causes of the current crisis are found in the mortgage market, the industry has evolved and changed since the earlier crisis. The elimination of a dedicated mortgage lending charter would not have eliminated the current crisis.

In the 1980s, the thrift industry was more limited in the activities in which it could engage and in the loan products institutions could offer to consumers. In a period of rapidly rising interest rates, many thrift institutions held long term fixed rate mortgages on their books while at the same time paying high rates on deposits to meet competition. The mortgage banking industry was not mature and the use of the secondary mortgage market was not widespread, therefore the long term fixed rate assets originated by thrifts created an interest rate mismatch on the books of the institutions. As a result of the earlier crisis, the OTS developed a proprietary interest rate risk model and expertise in supervision of institutions likely to have interest rate risk concerns. Throughout varied interest rate environments, the industry has not experienced the problems of the 1980s.

However, interest rate risk was not a primary cause of the current crisis and the mortgage related causes of the current crisis are already the subject of revised guidance at the OTS and the other Federal banking agencies. Unlike the problems of the 1980s, there are a number of causes of the mortgage related problems that surfaced in the current crisis.

First, during the recent housing boom, credit was extended to too many borrowers who lacked the ability to repay their loans when interest rates rose on the adjustable rate loans. For home mortgages, some consumers received loans based on their ability to pay introductory teaser rates, an unfounded expectation that home prices would continue to rise, inflated income figures, or other underwriting practices that were not as prudent as they should have been.

In addition, mortgage related problems are in part the result of inadequate supervision of State entities that had no Federal over-

sight. Another factor was the growth of the secondary market and the ability of lenders of any charter type or organizational form to fund lending activities with sales of originated loans. Whether it was the entities that originated the loans or the numerous entities that packaged the loans and sold them as part of securities, the entities involved were not always supervised by Federal banking regulators and that lack of supervision is a more direct contributor to the crisis than the existence of a charter that focuses on mortgage lending.

There are many lessons learned from the current crisis, but one of them is not that Congress should eliminate the thrift charter or a charter that focuses on housing finance. Homeownership continues to be an important policy objective for Congress. Consumers deserve to have the option of obtaining a loan from a dedicated home and consumer lender that is able to offer products that meet that consumer's needs.

Q.5. Should banking regulators continue to be funded by fees on the regulated firms, or is there a better way?

A.5. As a general matter, we believe that bank regulatory agencies (agencies) be funded by the institutions that they regulate. The alternative, funding the agencies with tax payer dollars through the appropriations process, is inherently problematic. Funding the agencies in this manner creates a taxpayer subsidy for the institutions. Moreover, subjecting the agencies to the appropriations process will make the agencies more vulnerable to political influence.

Now more than ever it is critical that the agencies be independent and free of political influence. However, funding the agencies through appropriations will do just the opposite. The Office of Federal Housing Enterprise Oversight (OFHEO) was subject to the appropriations process and as such was very vulnerable to political influence. For example, in 2004 OFHEO investigated accounting improprieties at Fannie Mae and that entity used the appropriations process to hinder the agency, portraying it as over its head on complex financial matters. This resulted in the Senate Appropriations Committee voting to hold back \$10 million of a proposed funding increase until OFHEO got a new director. (S. Rep. No. 108-353, at 71.)

It is critical that the agencies have the resources necessary to effectively regulate institutions. As was the case with OFHEO, Congress can withhold or threaten to withhold such funds. Even in the absence of such actions, Continuing Resolutions (CR) and other appropriations law requirements may hinder the agencies in achieving their mission. Beginning in October of every year and until a yearly appropriations bill is passed, agencies under the appropriations process are typically under a hiring freeze and are severely restricted in their expenditures under a CR. On January 21, 2004, Annando Falcon, then Director of OFHEO testified that Congress' protracted FY04 appropriations process placed "severe constraints" on OFHEO's capacity to implement reforms at Freddie Mac and carry out other oversight responsibilities. Director Falcon told the House Financial Services Capital Markets Subcommittee that "[t]he short-term continuing resolutions we are operating under prevent us from hiring the additional examiners, accountants and

analysts we need to strengthen our oversight. In addition, we are unable to hire the help we need to conduct our review of Fannie Mae. If the long term [continuing resolution] is enacted which freezes our budget at 2003 levels, we will need to scale back oversight at a time when greater oversight has never been more urgent.” (*Special Examination of Freddie Mac: Hearing Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. 8-9 (January 21, 2004) (statement of Armando Falcon, Director of Office of Federal Housing Enterprise Oversight.))

Some believe that a banking agency may supervise an institution less vigorously if it fears that the institution will switch charters and the agency will lose a funding source.

However, there is no evidence that this is the case and we strongly disagree with this suggestion.

Q.6. Why should we have a different regulator for holding companies than for the banks themselves?

A.6. Since the establishment of the savings and loan holding company, the OTS and its predecessor have regulated savings associations and their holding companies. Regulators have greater oversight into an institution and the holding company if they have the same supervisor. OTS disagrees that the institution and the holding company should have a different regulator. An exception to this general statement is if the holding company is so large or interconnected with other financial services companies that a systemic regulator also will provide oversight.

OTS has long had authority to charter and regulate thrift institutions and the companies that own or control them. The agency has a comprehensive program for assessing and rating the overall enterprise as well as the adequacy of capital, the effectiveness of the organizational structure, the effectiveness of the risk management framework for the firm and the strength and sustainability of earnings. OTS performs capital adequacy assessments on an individualized basis for the firms under our purview with requirements as necessary, depending on the company’s risk profile, its unique circumstances and its financial condition.

The net effect of this approach has been a strong capital cushion for the holding companies OTS supervises and the ability for the firms under our purview to support the insured depositories within their corporate structures. It is because the agency supervises the institution and the holding company that the impact of the holding company activities on the institution can be assessed on a regular basis.

Q.7. Assuming we keep thrifts and thrift holding companies, should thrift holding companies be regulated by the same regulator as bank holding companies?

A.7. As explained more fully in the answer above, thrifts and thrift holding companies should continue to have the same supervisor. The regulatory framework that has been developed for the institution and its holding company provides a seamless supervisory process for savings associations and their holding companies. The benefits of having the same regulator for the institution and the holding company include the supervisor’s ability to view the institution and

the holding company as a whole and judgments based on all of the information.

Q.8. The proposed risk council is separate from the normal safety and soundness regulator of banks and other firms. The idea is that the council will set rules that the other regulators will enforce. That sounds a lot like the current system we have today, where different regulators read and enforce the same rules different ways. Under such a council, how would you make sure the rules were being enforced the same across the board?

A.8. The Administration has proposed the creation of the Financial Services Oversight Council (Council) to be chaired by the Secretary of the Treasury and to include the heads of the Federal banking agencies and other agencies involved in the regulation of financial services. The Council will make recommendations to the Board of Governors of the Federal Reserve System (FRB) concerning entities that should be designated as systemically significant (Tier 1 FHCs). The FRB will consult the Council in setting material prudential standards for Tier 1 FHCs and in setting risk management standards for systemically important payment, clearing, and settlement systems and activities. The Council will also facilitate information sharing, provide a forum for discussion of cross-cutting issues and prepare an annual report to Congress on market developments and emerging risks. Under the Administration's proposal, the Council would not be authorized to promulgate rules.

Q.9. Mr. Bowman, in your statement you defend your agency's regulation of thrifts and thrift holding companies, however you never mention AIG. How do you defend your agency's performance with that company?

A.9. Commencing in 2005, OTS actions demonstrated a progressive level of supervisory criticism of AIG's corporate governance culminating in a communication to the company in 2008 which discussed the supervisory rating downgrade and a requirement to provide OTS with a remediation plan to address the risk management failures. OTS criticisms addressed AIG's risk management, corporate oversight, and financial reporting.

It is critically important to note that AIG's crisis was caused by liquidity problems, not capital inadequacy. AIG's liquidity was impaired as a result of two of AIG's business lines: (1) AIGFP's "super senior" credit default swaps (CDS) associated with collateralized debt obligations (CDO), backed primarily by U.S. subprime mortgage securities and (2) AIG's securities lending commitments. While much of AIG's liquidity problems were the result of the collateral call requirements on the CDS transactions, the cash requirements of the company's securities lending program also were a significant factor.

AIG's securities lending activities began prior to 2000. Its securities lending portfolio is owned *pro rata* by its participating, regulated insurance companies. At its highest point, the portfolio's \$90 billion in assets comprised approximately 9 percent of the group's total assets. AIG Securities Lending Corp, a registered broker-dealer in the U.S., managed a much larger, domestic securities lending program as agent for the insurance companies in accordance with

investment agreements approved by the insurance companies and their functional regulators.

The securities lending program was designed to provide the opportunity to earn an incremental yield on the securities housed in the investment portfolios of AIG's insurance entities. These entities loaned their securities to various third parties, in return for cash collateral, most of which AIG was obligated to repay or roll over every 2 weeks, on average. While a typical securities lending program reinvests its cash in short duration investments, such as treasuries and commercial paper, AIG's insurance entities invested much of their cash collateral in AAA-rated residential mortgage-backed securities with longer durations.

Similar to the declines in market value of AIGFP's credit default swaps, AIG's residential mortgage investments declined sharply with the turmoil in the housing and mortgage markets. Eventually, this created a tremendous shortfall in the program's assets relative to its liabilities. Requirements by the securities lending program's counterparties to meet margin requirements and return the cash AIG had received as collateral then placed tremendous stress on AIG's liquidity.

Q.10. I asked Chairman Bair this question a few weeks ago, so this is for the rest of you. All of the largest financial institutions have international ties, and money can flow across borders easily. AIG is probably the best known example of how problems can cross borders. How do we deal with the risks created in our country by actions somewhere else, as well as the impact of actions in the U.S. on foreign firms?

A.10. OTS exercises its supervisory responsibilities with respect to complex holding companies by communicating with other functional regulators and supervisors who share jurisdiction over portions of these entities and through our own set of specialized procedures. With respect to communication, OTS is committed to the framework of functional supervision Congress established in Gramm-Leach-Bliley. Under Gramm-Leach-Bliley, the consolidated supervisors are required to consult on an ongoing basis with other functional regulators to ensure those findings and competencies are appropriately integrated into the assessment of the consolidated enterprise and, by extension, the insured depository institution.

As a consolidated supervisor, OTS relies on effective communication and strong cooperative relationships with the relevant primary supervisors and functional regulators. Exchanging information is one of the primary regulatory tools to analyze a holding company and to ensure that global activities are supervised on a consolidated basis. Approximately 85 percent of AIG, as measured by allocated capital, is contained within entities regulated or licensed by other supervisors. AIG had a multitude of regulators in over 100 countries involved in supervising pieces of the AIG corporate family. OTS established relationships with these regulators, executed information sharing agreements where appropriate, and obtained these regulators' assessments and concerns for the segment of the organization regulated.

As part of our supervisory program for AIG, OTS began in 2005 to convene annual supervisory college meetings. Key foreign super-

visory agencies, as well as U.S. State insurance regulators, participated in these conferences. Part of the meetings was devoted to presentations from the company. In this portion, supervisors had an opportunity to question the company about any supervisory or risk issues. Another part of the meeting included a “supervisors-only” session, which provides a venue for participants to ask questions of each other and to discuss issues of common concern regarding AIG. OTS also used the occasion of the college meetings to arrange one-on-one side meetings with foreign regulators to discuss in more depth significant risk in their home jurisdictions.

This notion of consolidated supervision in a cross-border context is a widely accepted global standard implemented by most prudential supervisors. The key concepts of cross-border consolidated supervision have been supported by the Basel Committee on Banking and reflected in numerous publications. This framework has been embraced by the International Monetary Fund and World Bank and utilized in connection with their Financial Sector Assessment Program (FSAP) which is an assessment of countries’ financial supervisory regimes.

STRENGTHENING AND STREAMLINING PRUDENTIAL BANK SUPERVISION

TUESDAY, SEPTEMBER 29, 2009

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

The Committee met at 2 p.m. in room SD-538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order.

Let me inform my colleagues here, my good friend, Richard Shelby, is stuck in an airport in Birmingham trying to get back, and so I left a message for him that when he arrives about 10 or 11 this evening, that Senator Corker will call him and read him the entire testimony today. He would like that. He would appreciate that.

[Laughter.]

Chairman DODD. So what we will do here is I will make a few opening comments and I will ask if either of my colleagues would like to be heard at all and we will get right to our witnesses. We thank them for joining us here today in this hearing on "Prudential Bank Regulation: Should There Be Further Consolidation?"

I know we have had a lot of informal conversations with each other over many, many months on this subject and many others related to the reform of the financial regulatory structure. As I have said over and over again, while I think some of us are getting closer to firmer ideas, I believe most of us here are still very anxious to hear from people who bring a particular knowledge and expertise, as our witnesses do here today, on this subject matter. So we are interested in your thoughts.

We all understand here how important this subject matter is. We also understand how important it is that we do it right and that we realize we are doing things here that have not been done in years, and so as we chart forward, we want to make sure that we are doing so carefully and thoughtfully. So while I know there are those who are impatient, that while we haven't answered all the questions, even though the problems that emerged a year ago have not been entirely solved, I think it is important that we do it carefully and right, and that is our determination on this Committee.

This afternoon, we will have a chance to hear from four very knowledgeable witnesses on the subject matter. I have read all of your testimony. I think it has been tremendously helpful. I think

you go beyond, in some cases, talking about the single prudential regulator or the consolidation of regulation to other areas, as well, so while we are talking about that subject matter, certainly my colleagues don't need any advice from me on the subject matter, but clearly, the expertise is at this table. We would invite questions regarding a wide subject matter, in addition to the one that is the title of the hearing today.

So with that, this afternoon we examine how best to ensure the strength and security of our banking system. I would like to thank our witnesses again for returning to share your expertise after the last hearing was postponed.

Today, we have a convoluted system of bank regulators created by an almost historical accident. I think most experts would agree that no one would have designed a system that worked like this. For over 60 years, Administrations of both political parties, Members of Congress across the political spectrum, commissions, and scholars have proposed streamlining this irrational system.

Last week, I suggested further consolidation of bank regulators would make a lot of sense. We could combine the Office of the Comptroller of the Currency and the Office of Thrift Supervision while transferring bank supervision authorities from the Federal Deposit Insurance Corporation and the Federal Reserve and leaving them to focus on their core functions.

Since that time, I have heard from many who have argued that I should not push for a single bank regulator. The most common argument is not that it is a bad idea, but rather, consolidation is too politically difficult to achieve. That argument doesn't work terribly well with me, nor, I suspect, with many, if not most, of my colleagues.

Just look what the *status quo* has given us. In the last year, some of our largest banks needed billions of dollars of taxpayer money to prop them up and dozens of smaller banks have failed outright. It is clear that we need to end charter shopping, where institutions look around for the regulator that will go easiest on them. It is clear that we must eliminate the overlaps, redundancies, and additional red tape created by the current alphabet soup of regulators. We don't need a super-regulator with many missions, but a single Federal bank regulator whose sole focus is the safe and sound operation of our Nation's banks. A single operator would ensure accountability and end, I think, the frustrating "pass the bucket" excuses that we have been faced with over these many, many months.

We need to preserve our dual banking system, and I feel just as strongly about that point as I do the earlier point. State banks have been a source of innovation and a source of strength, tremendous strength, in our communities. A single bank regulator can work, I think, with the 50 State bank regulators. Any plan to consolidate bank regulations would have to ensure community banks are created appropriately. Community banks did not cause the crisis and they should not have to bear the cost or burden of increased regulation necessitated by others. Regulation should be based on risk. Community banks do not present the same type of supervisory challenges that large counterparts do.

But we need to get this right, as I said a moment ago, which is why you are all here today. I am working again with Senator Shelby and other Members of the Committee and colleagues here to find a consensus that we can craft on this incredibly important bill.

So with that, unless one of my other colleagues wants to be heard for a few minutes on opening up, I will turn to our witnesses.

Our first witness—and I will introduce all of them briefly here—Eugene Ludwig, is the Chief Executive Officer of the Promontory Financial Group. Before assuming that responsibility, Gene served as the Vice Chairman and Senior Control Officer of Bankers Trust Corporation, which he joined in 1998. He served as the Comptroller of the Currency from 1993 to 1998, and prior to joining the OCC, was a partner in the law firm of Covington and Burling.

Martin Baily is a Senior Fellow for Economics at the Brookings Institution. Dr. Baily also serves as the Cochair of the Pew Task Force on Financial Sector Reform and is a senior advisor to McKinsey and Company. He served as Chairman of the Council of Economic Advisors under the Clinton administration from 1999 to 2001, and prior to that was a member of the same Council from 1994 to 1996.

Richard Carnell is an Associate Professor at the Fordham University School of Law. He previously served as the Assistant Secretary for Financial Institutions at the Treasury from 1993 to 1999. And prior to that, Mr. Carnell was also a Senior Counsel to this very Committee, from 1989 to 1993.

Richard Hillman is the Managing Director of the Financial Markets and Community Investment Team of the U.S. Government Accountability Office. He has been with GAO for 31 years and his team looks at the effectiveness of regulatory oversight in the financial and housing markets and the management of community development programs.

We are honored that all four of you are with us today. We thank you for your service, your past service, and your willingness to participate in today's conversation.

All of you have been before this Committee many times in the past and I will not limit you in a strict fashion to the time, but if you would try to keep it in that 5 to 7 minutes—and I know your testimony goes on longer than that, and the testimony, the full testimony and comments and supporting data, we will include as part of the record, as well.

Gene, we welcome you back to this Committee.

STATEMENT OF EUGENE A. LUDWIG, CHIEF EXECUTIVE OFFICER, PROMONTORY FINANCIAL GROUP, LLC

Mr. LUDWIG. Chairman Dodd, and to Ranking Member Shelby, who is not here, and other distinguished Members of this Committee, I am honored to be here today and I want to commend you and the staff for the thoughtful way in which you have examined the causes of the financial crisis and the need for reform in this area. Under your leadership, Chairman Dodd and Ranking Member Shelby, the bipartisan and productive traditions of the Senate Banking Committee have continued.

In this regard, it should be noted that the need for an end-to-end independent consolidated banking regulator, the subject you have

asked me to address today, has been championed over the years by Members of the Senate Banking Committee, including its Chairman, as well as Treasury Secretaries from both sides of the aisle.

Consistent with this tradition, the Administration's white paper is directionally helpful and commendable. While refinements to the white paper are needed, this 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 developments to the debate in this area.

Lamentably, the financial regulatory problem we face is not just the current crisis. Over the past 20-plus years, we have witnessed the failure of hundreds of U.S. banks and bank holding companies, supervised by every one of our regulatory agencies. By the end of this year alone, well over 100 U.S. banks will have failed, costing the Deposit Insurance Fund tens of billions of dollars. Before this crisis is over, we will witness the failure of hundreds more.

In the face of this irrefutable evidence, it is impossible to say there is not a very serious problem with our regulation of financial services organizations. There are three things, however, this problem is not. It is not about the lack of talented people in our regulatory agencies. It is not about weak regulation or weaker bankers. The problem is in large part—the problem stems from a dysfunctional regulatory structure, a structure that exists nowhere else in the world and no one wants to copy, a structure that reflects history, not deliberation.

The recent financial crisis has accentuated many of the shortcomings of the current regulatory system. Needless burdens that weaken safety and soundness focus, lack of scale needed to address problems in technical areas, regulatory arbitrage where the ability to select or threaten to select a weaker supervisor tears at the fabric of solid regulation, delayed rulemaking, regulatory gaps, limitations on investigations, where one agency cannot seamlessly examine and resolve a problem from a bank to its nonbank affiliate, and diminished international leadership. What is needed and what would resolve these problems is an end-to-end independent consolidated banking supervisor.

Now, there have been a number of misconceptions about what a consolidated end-to-end institutional bank regulator is and what it is not. First, an end-to-end supervisor is not a super-regulator along the lines of Britain's FSA. The end-to-end consolidated institutional supervisor would not regulate financial markets like the FSA, would not establish consumer protection rules like the FSA, would not have resolution authority, would not have deposit insurance authority or any central banking functions.

The consolidated end-to-end institutional regulator would focus only on the prudential issues applicable to financial institutions, and this model has been quite successful elsewhere in the world. I think this is really quite important.

For example, the Office of the Superintendent of Financial Institutions, OSFI, in Canada, and the Australian Prudential Regulatory Authority, called APRA, in Australia have been quite successful consolidated supervisors even in the current crisis, where

Canadian and Australian banks have fared much better than our own.

There has been a second misconception that a consolidated regulator that regulates enterprises chartered at the national level cannot fairly supervise smaller community organizations and that it would do violence to our dual banking system. I might say as an aside, I, like the Chairman, believe the dual banking system is alive and well and an important fabric of our banking system and this would not do violence to it.

In fact, interesting enough, even today, the OCC supervises well over a thousand community banking organizations whose businesses are local in character. That is, the national supervisor supervises over a thousand small banks. In fact, it is the majority of the banks it supervises, the vast majority, and they choose that as a matter of their own predilection, not by rule. Indeed, today, all our Federal regulators regulate large institutions and smaller institutions. A new consolidated supervisor at the Federal level would merely pick up the FDIC and Federal Reserve examination and supervisory authorities.

To emphasize, all the consolidated supervisor would do is take the Federal component and move it to another Federal box. It would not change the regulation or the fabric of that supervision.

Third, some have claimed that a consolidated institutional supervisor would not have the benefit of other regulatory voices. This would clearly not be the case, as a consolidated institutional supervisor would fulfill only one piece of the regulatory landscape. The Federal Reserve, Treasury, SEC, FDIC, CFTC, FINRA, FINCEN, OFAC, and the 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 multiple financial regulators at the Federal level and 50 bank regulators, 50 insurance regulators, and 50 securities regulators at the State level. It seems to me that is a lot of voices.

Fourth, some have also claimed that the primary work of the Federal Reserve—monetary policy, payment system, and acting as the bank of last resort—and the FDIC—deposit insurance—would be seriously hampered if they did not have supervisory responsibility. The evidence does not support these claims.

One, 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 the other agencies.

Two, there are not now, to my knowledge, any limitations on the ability of the Federal Reserve or the FDIC to collect any bank supervisory data. Indeed, if need be, the Federal Reserve or the FDIC can accompany another agency's examination team to obtain relevant data or review relevant practices.

Three, 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.

And four, even if the FDIC were not the supervisor of State chartered banking entities, the FDIC would continue to have back-up

supervisory authority and be able to be resident—resident—in any bank it chose.

Finally, I would note that it is important that the new consolidated supervisor be an independent agency for at least three reasons. First, banking supervision should not be subject to political influence.

Second, the agency and the agency head needs the stature of the Federal Reserve, SEC, or FDIC to attract talented people and to be taken seriously by the other agencies.

Third, and this, I think, is critically important, Congress, in fulfilling its oversight function—its critical oversight function—must hear the unfettered truth about the banking system from the head of its supervisory agency, not views filtered through another department or agency. And indeed, I would go further. I think it is incredibly difficult for you to fulfill your oversight responsibilities with an alphabet soup of regulators. Indeed, having regulators that have clear missions, it seems to me, makes it possible for you to exercise your critical function in a more effective way. If one pushed these together even more, as has been suggested by some, I think it becomes almost unmanageable for Congress.

In sum, our country greatly needs a consolidated independent end-to-end institutional regulator. Without one, we will not have financial stability, in my view, and we will continue to be victimized by periods of bank failures and follow-on credit crunches that deteriorate our economy.

Thank you very much.

Chairman DODD. Thank you very much, Gene Ludwig. We appreciate it very much.

Dr. Baily, we thank you, as well, for being with us.

**STATEMENT OF MARTIN N. BAILY, SENIOR FELLOW,
ECONOMIC STUDIES, THE BROOKINGS INSTITUTION**

Mr. BAILY. Well, thank you, Chairman Dodd and Members of the Committee, to give me a chance to talk about this issue.

The summary of my testimony is, number one, I think that the best guide to financial reform is the objectives approach, which divides up regulation into microprudential, macroprudential, and conduct of business regulation. So we have to make sure that all parts of the financial sector are adequately supervised, we don't have gaps in regulation. We also want to make sure we don't have duplicative agencies. After all, there were plenty of regulators. There were rooms full of regulators. They didn't prevent this crisis.

My second point is that the quality of regulation must be improved regardless of where it is done, and I don't want to denigrate anybody in the regulatory agencies, but I do think there is a problem that they may not always be well enough paid, have enough experience, or have the kind of stature that they need to deal with our very complex financial sector, particularly the large global banks. I don't think we want a situation where people are in Government jobs for a while and then they move over to the financial sector, viewing that as sort of where they are going to make their money. I think we want the regulatory jobs to be desirable and stable jobs and get the best people we can.

I agree with the Chairman and very much with Gene Ludwig that we need a single Federal microprudential regulator, combining the supervisory functions currently carried out at the Fed, the OCC, the OTS, the SEC, and the FDIC. I think this regulator should partner closely with State regulators. You mentioned the importance of the community banks, and I agree with you on that. I would say, however, that some of the State chartered nonfinancial institutions were a source of a lot of the bad mortgages that were made, so I think having the right partnership between the Federal regulator and the State chartered enterprises is important. I think there should be a sharing of information there and perhaps of standards and appropriate methods and data.

I do think, and this is going a little beyond the immediate discussion of this hearing, but I do think the U.S. does need an effective conduct of business regulator. That is an important part. As Gene said, that has been combined in the U.K., where the FSA was both the prudential regulator and the conduct of business regulator, and cobbling it all, the whole lot that was done there, I think that is a mistake. I think having a separate conduct of business regulator is a good idea.

My own view is it would be nice to have that in a single agency, and I think the SEC is probably the place to put it, although the SEC, I must say, did not do a very good job in this crisis. But I think potentially the SEC should be the place that looks after small shareholders and also looks after consumers, so it would have a CFPA division within the SEC. Now, I know there is a case for having a separate consumer agency and I am not diametrically opposed to that. I think there are some advantages to the consolidation of having conduct of business regulation in one place, but a good CFPA on its own would be fine.

Now, this structure that we are describing takes away from the Fed an important part of its existing power, which is what has been to supervise the bank holding companies, most of the large banks and a number of the smaller banks. I think that is the right thing to do. I agree with Gene. I don't think this is something that the Fed has done particularly well. They are obviously paying a lot more attention to it now than they used to, but historically, I don't think that is something that they have done very well.

I share that view with my colleague, Alice Rivlin, who I think has testified to this Committee, and she was there and saw the point that Gene Ludwig made, which is that the prudential people haven't typically had a lot of say on Open Market Committee meetings. That hasn't been a main thing.

I do think it is very important that the Fed, as the lender of last resort to the financial sector, does have to have information about what is going on in the banks. I think that was a significant failure in the U.K., where the FSA and the Bank of England were so separate and were not talking to each other, and I think Mervyn King, the head of the Bank of England, thought it was inappropriate for him to talk too much to the FSA. He wanted the independence of the Bank of England when they were making monetary policy. You know, I see his argument, but I think that was a big mistake and one of the things that got them into trouble.

So I think we should have a lot of lines of communication shared between the regulators and the Federal Reserve so that they can set monetary policy with the adequate amount of information and that they are aware of what is going on in the banks, and if they need to be a lender of last resort, that is not suddenly sprung on them. But I think they don't have to be the people that are doing the day-to-day supervision.

Another point I would like to make in this regard is that the big bank holding companies, or the big banks, as we know, both investment banks or the traditional commercial banks, are run as single entities. So the idea that you had a bank holding company which was sort of a separate entity from the bank itself really is not the way things operate. These were run from the top and these banks would sort of come up with a new line of business, something that was going to be profitable, and they would discuss it, and then as someone was walking about the door, they would sort of say, well, which legal entity shall we put this in, and the answer to that was typically, well, where would they get the most favorable tax treatment? Where would they get the most favorable regulatory treatment? It is not as if these things were really different entities.

So I think another advantage of having a single prudential regulator is that they would regulate these businesses top to bottom as single companies, which is what they are.

I have used up my time. The last thing I want to say is to reinforce the point that Gene made. I think we both had the same reaction when we attended the hearing in August. You know, it is natural for regulators to say, well, don't close my agency. Mine is all right. When you came back and some of the other Members of the Committee came back and said, well, shouldn't we consolidate, shouldn't we make this a more rationally organized regulatory structure, the answer came back, well, the U.K. had trouble and they had this single regulator, so we don't see why that should do any good.

That prompted, I think, both of us to go take a look—Gene probably knew already, but I actually went to take a look at regulation around the world, not covering every country, but trying to cover several countries, and particularly the English-speaking countries which tend to have some similarity of their institutions, and you are right.

Canada, I think, did a much better job. They do actually have quite a few different agencies, so they weren't my ideal. I think Australia, which actually the Paulson Blueprint pointed to, is to be commended. They took quite a while. They decided, what is the best way to regulate. They took their time in doing it. They consolidated in an appropriate way.

What happened in the U.K.—and I grew up in the U.K., I am fond of the U.K., but they didn't do this very well—Gordon Brown came in as Chancellor of the Exchequer and he said, it is crazy to have all these agencies. I think he was right about that. That the functions that these different companies are performing are crossing boundaries and we want to have a single agency. But they hadn't made any preparation. They hadn't really laid the groundwork for doing it. They hadn't figured out how to do it well. And, in fact, the FSA remained really quite divided. There were a lot of

different subagencies within that, so they weren't communicating well, and as I said earlier, they weren't communicating with the Bank of England.

So I think the examples that were given last time to say, oh, other countries—a single agency doesn't work in other countries, I think that is wrong. I think if you look in the right place, you will find that having a single prudential regulator is pretty much what is the right choice to make, based on international experience.

Let me stop there. Thank you.

Chairman DODD. Thank you very much, Dr. Bailly.

Dr. Carnell? Thank you very much, Doctor, for being with us.

**STATEMENT OF RICHARD S. CARNELL, ASSOCIATE
PROFESSOR, FORDHAM UNIVERSITY SCHOOL OF LAW**

Mr. CARNELL. Mr. Chairman and Members of the Committee, our current bank regulatory structure is and remains a source of serious problems. Its defects are significant and longstanding. The system is needlessly complex, needlessly expensive, and imposes needless compliance burdens on banks. It impedes—it blunts regulators' accountability with a tangled web of overlapping jurisdictions and responsibilities, and it gives credence to the old saying, when everyone is responsible, no one is responsible.

The system wastes time, wastes energy. It hinders timely action by regulators. It brings policy down to the lowest common denominator that four agencies can agree on. And it takes a particular toll on far-sighted action, action aimed at preventing future problems. That is because so often in policymaking, there is someone who says, if it ain't broke, don't fix it. So it is a lot easier to get agreement when you wait until you are confronted with a problem than when you are trying to look ahead and head off problems to begin with.

Now, there is a straightforward solution to the problems we see from our fragmented regulatory system, and that solution is to unify the supervision of FDIC-insured depository institutions, banks and thrifts, in a single agency. Treasury Department Lloyd Bentsen offered that solution here in this room 15 years ago and it made sense at the time. I worked with him in preparing that proposal, and I think the events of the last 15 years bear out the wisdom of that approach.

This new agency would take on the existing bank regulatory responsibilities of the OCC, OTS, Federal Reserve, and FDIC. The Federal Reserve would retain all its existing central banking functions, including monetary policy, the discount window, and the payment system. The FDIC would retain all its deposit insurance powers and responsibilities, including back-up examination and enforcement authority.

On top of that, under the approach I propose, the Fed and the FDIC would be on the board of the new agency, let us say a five- or seven-member board with those two agencies represented. The Fed and FDIC could have their examiners participate in examinations conducted by the new agency, and they would have full access to supervisory information. So the Fed and FDIC would get all the information they get now and their examiners could be part of

teams in all FDIC-insured banks, which is more access than they customarily enjoy now.

This straightforward structure would be a major improvement over the current fragmented structure. It would promote clarity, efficiency, accountability, and timely action. Equally important, it would give the bank regulator greater independence from special interest pressure. That is, this new agency would regulate the full spectrum of FDIC-insured institutions. There wouldn't be the sort of subspecialization category like we see with thrift institutions.

Now, if you look at the thrift debacle, for example, you see that thrift regulation was better when it was done by agencies that had a broad jurisdiction than when it was done by specialized thrift-only regulators. So, for example, at the Federal level, we had thrifts regulated by both the FDIC, which regulated the traditional savings banks, and we had thrifts regulated by the specialized Federal Home Loan Bank Board. FDIC-regulated thrifts were much less likely to fail and, if they did fail, caused smaller losses than the Home Loan Bank Board-regulate thrifts, and we see the same thing at the State level.

At the State level, in about two-thirds, three-quarters of the States, the State Banking Commissioners supervise thrifts, and in those States, the losses to the insurance fund were much lower than we saw in States with specialized thrift regulators, and that is basically because the thrift regulators had no reason for being if there wasn't a thrift industry, and so they looked for every way to keep thrift institutions going, even when, in fact, it was unrealistic at that point. The result was a failure to deal effectively with troubled thrifts, much larger losses to the Deposit Insurance Fund.

A unified structure would have another major advantage. It would recognize the reality of how banking organizations actually operate, and Dr. Bailly already touched on this, as well. Under the existing system, each agency looks at only part of the organization. But in these organizations, you may, in fact, have the various parts doing business with each other extensively, and to evaluate risk, you need to look at the whole, think about the whole, and it sure helps in doing that to be responsible for the whole.

So the fragmented system hinders the agency from getting the full picture. Here is how Secretary Bentsen described the problem. Under our current system, any one regulator may see only a limited piece of a dynamic, integrated banking organization when a larger perspective is crucial, both for effective supervision of the particular organization and for an understanding of broader industry conditions and interests.

Mr. Chairman, if I could, I wanted to speak a bit to the question of holding company regulation, which came up earlier. First, I want to note something that may not be widely appreciated, and that is that holding companies as a major subject of regulation, that thing is unique to the United States. In other countries, the regulation focuses on the bank. Regulators look out, reach out, but it is not like we have got people devoting their careers to the Bank Holding Company Act.

And here is what two of the leading experts, Pauline Heller and Melanie Fein, say. Bank holding companies have no inherent necessity in a banking system. They developed in the United States

only because of our unique banking laws which historically limited geographic location and activities of banks. Their only material purpose has been to serve as vehicles for getting into things banks couldn't get into directly.

So this puts it into perspective. There is nothing magical. There is nothing high priestly about bank holding company regulation. There is no need for a separate holding company regulator. A bank regulator can fully handle all the functions of a holding company regulator, policing the banks' transactions with the banks and looking at overall risk.

In conclusion, Secretary Bentsen, speaking from this table in 1994, underscored the risk of continuing to rely on what he called "a dilapidated regulatory system that is ill-defined to prevent future banking crises and ill-equipped to cope with crises when they occur." He observed in words eerily applicable to the present that our country had just emerged from its worst financial crisis since the Great Depression, a crisis that our bank regulatory system did not adequately anticipate or resolve.

And he issued this warning, which we would yet do well to heed. If we fail to fix the system now, the next financial crisis we face will again reveal its flaws, and who suffers then? Our banking industry, our economy, and potentially the taxpayers. You have the chance to help prevent that result.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much for your testimony. I was very fond of Lloyd Bentsen, served with him here. He was a wonderful Member of the Senate and a very good Secretary of the Treasury as well. So thank you for being with us.

Welcome, Mr. Hillman. Nice to see you, and thank you for being here. Thank you for your service to the GAO, 31 years. Congratulations on that contribution.

**STATEMENT OF RICHARD J. HILLMAN, MANAGING DIRECTOR,
FINANCIAL MARKETS AND COMMUNITY INVESTMENT TEAM,
GOVERNMENT ACCOUNTABILITY OFFICE**

Mr. HILLMAN. Thank you very much. Mr. Chairman and Members of the Committee, I am pleased to be here today to discuss issues relating to efforts to reform the regulatory structure of our Nation's financial system.

In January 2009, we reported on gaps and limitations in our current structure, and we presented a framework for evaluating proposals to modernize the U.S. financial regulatory system. Given the importance of the U.S. financial sector to the domestic and international economies, we also added modernization of the outdated regulatory structure as a new area to our high-risk list because the fragmented and outdated regulatory structure was ill-suited to meeting the challenges of the 21st century.

My statement today, which is based on prior reports that we have completed, focuses on how regulation has evolved and recent work that further illustrates the significant limitations and gaps in the existing regulatory structure, the experiences of countries with other types of varying regulatory structures and how they fared during the financial crisis, and our reviews on certain aspects and proposals to reform the regulatory system.

I would like to make the following points:

First, the current U.S. financial regulatory system is a fragmented and complex arrangement of Federal and State regulation that has been put into place over the past 150 years but has not kept pace with major developments in financial markets and products in recent decades. My prepared statement details numerous examples from our prior work identifying major limitations of the Nation's fragmented banking regulatory structure. For example, in July, we reported that less comprehensive oversight by various regulators responsible for overseeing fair lending laws intended to prevent lending discrimination may allow many violations by independent mortgage lenders to go undetected. That same month, we also reported that regulatory capital measures did not always fully capture certain risks and that none of the multiple regulators responsible for individual markets or institutions had clear responsibility to assess the potential effects or the build-up of systemwide leverage.

Recent proposals to reform the U.S. financial regulatory system include some elements that would likely improve oversight of the financial markets and make the system more sound, stable, and safer for consumers and investors. For example, under proposals under the Administration and others, new regulatory bodies would be created that would be responsible for assessing threats that could pose systemic risks. Our past work has clearly identified the need for a greater focus on systemwide risks in the regulatory system.

In addition, the Administration and others are proposing to create a new entity that would be responsible for ensuring that consumers of financial services are adequately protected. Our past work has found that consumers often struggled to understand complex financial products, and the various regulators responsible for protecting them have not always performed effectively. As a result, the creation of a separate consumer protection regulator is one sound way for ensuring that consumers are better protected from unscrupulous sales practices and inappropriate financial products.

However, our analysis indicates that additional opportunities for further consolidating the number of Federal regulators exist that would decrease fragmentation, reduce the potential for differing regulatory treatment, and improve regulatory independence. For example, the Administration's proposal would only combine the current regulators for national banks and thrifts into one agency while leaving the three other depository institution regulators—the Federal Reserve, FDIC, and the regulator for credit unions, NCUA—intact. Our work has revealed that multiple regulators who perform similar functions can be problematic. When multiple regulators exist, variations in their resources and expertise can limit their effectiveness.

The need to coordinate their actions can hamper their ability to quickly respond to market events, and institutions engaging in regulatory arbitrage by changing regulators through reduced scrutiny or their activities or to threaten to change regulators in order to weaken regulatory actions against them.

Having various regulators that are funded by assessments from the institutions they regulate can also in such regulators become

overly dependent on individual large institutions for funding, which could compromise their independence in overseeing such firms. As a result, we would urge the Congress to consider additional opportunities to consolidate regulators as it deliberates reform of our regulatory system.

Finally, regardless of any regulatory reforms that are adopted, we urge the Congress to continue to actively monitor the progress of such implementation and be prepared to make legislative adjustments to ensure that any changes in the U.S. financial regulatory system are as effective as possible. In addition, we believe that it is important that Congress provide for appropriate GAO oversight of any regulatory reforms to ensure accountability and transparency in any new regulatory system, and GAO stands ready to assist the Congress in its oversight capacity and evaluate the progress agencies are making implementing any changes.

Mr. Chairman and Members of the Committee, I appreciate the opportunity to discuss these critical issues and would be happy to respond to any questions at the appropriate time.

Chairman DODD. Thank you very, very much. Let me thank all of you on behalf of the Committee for your testimony and your observations. They have been very, very helpful this afternoon.

Let me pick up on the issue of the community banks and the issue of a single regulator, because I think this is where maybe the most contentious political problems arise. I want to underscore the point—I think, Gene, you made it, others may have made it as well—that we have a lot of community banks that are operating under Federal charters and, in fact, are regulated at the Federal level. I think you mentioned 1,000 or a number like that. And at a time, obviously, when they could have easily, under the present system, decided to migrate from that to a State charter—they may have had their own reasons for not doing so, but the fact that so many have stayed with a Federal regulator indicates a relatively high degree of satisfaction in terms of how they were being handled, in the midst of that same institution handling the Chases, the JPMorgans, and Bank of America and other large institutions. So you have the largest number of community banks in many ways maintaining a regulatory structure where there is duality. But it is of concern, and I think we need to address it in ways that are practical.

There have been some suggestions, something along this line, and I would like to maybe get a little more in the weeds on this. How do you envision, if we had a single regulator, a division within that regulator to be able to handle the concerns of the community banks, particularly ones that would be State chartered, how they would handle that in a way that would give them some degree of satisfaction that they are not going to be lumped together in a way that would diminish their capacity to be able to function and get lost in the shuffle? How do you do that?

I would ask all of you, and if you have got any ideas on that, I would be interested in your thoughts.

Mr. LUDWIG. Well, Mr. Chairman, I think that it is important for the new regulatory agency to have departments that are specialized in dealing with institutions of a particular size. The Comptroller's office currently has three segments: one deals with small

banks, one midsized, one large. I think that there are specialized techniques, ability to simplify supervision for community banks, and I think it is important.

In that regard, I think the same kind of sensitivity to small bank supervision can be found both at the Federal Reserve and the FDIC. Remember, the only thing that one would do in terms of this new agency would be to move the Federal component of the supervisory authority to the new agency. It would not change the component. But I think one can have a separate division that focuses on simplifying it. I think that Congress, in writing these rules itself, ought to mandate that simplified treatment—that one of the responsibilities of the new agency is to reduce burden wherever possible, particularly in terms of community and regional financial institutions.

Chairman DODD. Dr. Bailly.

Mr. BAILY. Yes, I agree very much with what Gene said. I think that can be handled within a single regulator. The Federal Reserve currently supervises the bank holding companies, and you think of them as the big ones. But, actually, some of them are pretty small. They have got quite a range. So they have been supervising both big and small banks.

So I think it is certainly possible to have a separate division within the prudential regulator that looks to the needs of community banks, and I think it is very important that small banks not be overburdened with regulation. One wants different requirements, perhaps, different capital requirements for a bank that has large overseas operations, subsidiaries. That has become—it seems too big to fail, although I hope we can overcome that problem. The needs there are very different than the community banks, and I think that should be part of the legislation taking account of that.

Chairman DODD. I should have asked this of Gene as well. In your examination of global examples, you mentioned Australia and Canada, and I do not know this, so I apologize for my ignorance on this. I do not know what the Australian banking system looks like. Is there duality there at all? Or is this all one system? Is there any place you looked at that has a comparable duality of systems that would—

Mr. BAILY. Well, there certainly are countries that have small banks. Germany has a lot of small banks, actually many of them State-owned banks that ended up buying quite a bit of CDOs as a matter of fact. So they did not always make good decisions.

Typically, in Canada, you have some small banks, but really the market is dominated by about five or half a dozen very large banks. So I do not think they are quite comparable to the U.S., which, as you say, or somebody said earlier, grew up because of geographical limitations.

I do not know whether you want to add to it.

Chairman DODD. Do you have anything on that, Gene?

Mr. LUDWIG. First, Canada does have a Federal system, and there are some smaller institutions. But there is no place on Earth that really quite has the number of commercial banking institutions that we do.

Having said that, the point is well taken that Germany does have a good many landesbanks, and I think a survey of the world

would reveal other consolidated supervisory mechanisms that deal with small banks and large banks and do it effectively. And I think Canada is probably a pretty good example, actually, though they are not as numerous.

Chairman DODD. Well, Germany is sort of the antithesis of ours. That is a highly decentralized system in many ways in Germany. Dr. Carnell.

Mr. CARNELL. Yes, three things. First, Secretary Bentsen's legislative proposal included a statutory requirement establishing a community banking division within the agency seeking to institutionalize a sensitivity to the ways community banks are different and the ways they should not be treated just the same as larger institutions.

And I think—and this is my second point—that something like that, even though in a sense it is just an outline of an idea, it sends a signal that Congress cares about it, that it is something that needs to be done. I think that is a signal that the agency will clearly hear.

And then, third, in any event the new agency would have every incentive to foster a healthy community banking system. The agency has no reason to favor large over small, and there are advantages to the agency when bankers come in, for example, to talk to Members of Congress, that people are having a positive experience with the new agency.

So there is absolutely no reason for the regulator to hold back from doing the best job it can. There is no reason why a unified regulator would do any less of a good job than what we see now where an agency like the OCC regulates from the largest banks down to some of the smallest.

Finally, you mentioned duality, and in case you were asking about a dual banking system, that is not something that you see abroad. That is, to my knowledge, a quirk of U.S. regulation having to do basically with some developments in the 1860s and 1870s.

Chairman DODD. Thank you very much.

Mr. Hillman.

Mr. HILLMAN. There clearly are ways to provide a voice for State banks or community banks and still achieve great consolidation of the banking regulatory structure. I agree with Rick that one of the ways in which you could achieve that would be to establish a division within that prudential regulator to serve the needs of community and State member institutions.

Another way of achieving that goal would also be, like the FDIC currently has with its board structure, to ensure that membership of that board might include members that have a background or might have been a prior community banker in the past. That would give that regulator the opportunity to have that voice heard at the highest levels of the institution.

Chairman DODD. Good idea. Good suggestion.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I thank each of you for your testimony. I know Gene and Marty we have talked with—a great deal about this and certainly appreciate the two of you coming in.

I am going to ask some questions that do not necessarily reflect my point of view but just to probe. I am open on all of these issues and am still, like many Members on this Committee, trying to figure out what is the best route or have you all propose something, and maybe a hybrid of that is best, who knows? But hopefully we will get to that—I know we will—before we regulate.

You mentioned the issue of having an alphabet soup of people coming to talk to us, and it is not unlike having witnesses come before our Committee with differing points of views in many ways. I have to tell you, I have enjoyed that. Each of the regulators, sometimes gleefully, sometimes not, points out the deficiencies of the other regulator. And I have to tell you, there is some merit in that. Just for what it is worth, you know, to have a captive regulator, much like we have with the GSEs, which would be the case with all banks, to me, could be very problematic. I think having feet on the ground sometimes gives you a sense—I know in my business it was very important to be in various States where we were building. As Senators, we go back home to our States to not be Washingtonized, and there is just some benefit of having feet on the ground, as the FDIC has argued and as the Fed has argued.

And then the OCC to me is the most procyclical—which what we are talking about is a super OCC. Let us face it. They are the most procyclical organization that we have. They move quickly in a direction that creates bubbles, and now they are out throughout the country. Anybody that has got a commercial real estate loan or anything like it is being criticized, and so they are creating, I think strongly creating a self-fulfilling prophecy.

So I would love to hear your comments about the RUBs being helpful in some cases and the competition being helpful, but also what would be in this to keep the OCC—super OCC, if you will—from being so procyclical as they are now.

Mr. LUDWIG. Well, Senator, a couple of comments. I agree with your comment that if one were to homogenize the entire regulatory system down to one, there would be something that would be lost. But we are not homogenizing it down to one.

First, the FDIC itself has back-up supervisory authority, which means the FDIC would have on-site continued responsibilities.

Second, as I mentioned, both the FDIC and the Fed would have serious information gathering and review authorities.

Senator CORKER. But that does not happen now. I mean, they do not share information now. I know you said we could put that in law, but that is problematic.

Mr. LUDWIG. Well, I am not honestly sure that is the case. There are certainly claims that that is the case. If it is the case, it is heart-stopping because in the midst of this crisis, one would assume that the information the Fed and the FDIC and other agencies need to do the job would be forthcoming or they would be squawking, I mean big time, to you and others.

In addition, we are talking about a systemic regulator. There is the SEC, the CFTC, FINRA. There are all these other agencies, and in terms of giving you the kind of diversity you need to hear other points of view, you will still have the 50 State bank supervisors that can be called up. So you get quite a—even with a sim-

plified Federal regulatory mechanism, you get quite a cacophony of other voices that I think is available.

As to your comment on procyclicality, I think that there is the nature of all regulators, and I think that actually if you looked at all the agencies, both at the Federal and State level, you would find that in times of stress they become tougher. You see the calls at the G-20 and others for more capital right now, sort of in a crisis.

Senator CORKER. Which creates a bigger crisis.

Mr. LUDWIG. Which has a tendency to be procyclical, which is not desirable. The Spanish had it right in terms of their—through their cycle provisioning and through their cycle capital rules, which I am very hopeful that will be adopted in this country.

But I do not think that is limited just to the OCC. It is something, I agree with you, that deserves criticism because an evenhanded effort and a push to an evenhanded effort is highly desirable.

Senator CORKER. And let me just—I know my time is about up. The clock must have been on 2 minutes today.

Chairman DODD. Your questions are so eloquent.

Senator CORKER. OK. There you go.

If you would—and I know Marty is getting—and this is my last, just to advance this a little bit, the procyclical piece to me is a huge problem that you do not necessarily create by your formula, but it is something that has not served us well. The same thing happens in 1990 and 1991, and we just do a really poor job of it.

There is nothing in your proposal that, for instance, changes—I mean, much of this is about rearranging the deck chairs and just getting different people—it is almost a family squabble. We sometimes refer to the insurance industry's issue the same way. But what they do is also very important, and, you know, the—for instance, the counterparty risk, I mean, is this—is there anything about any of this that changes their ability to really look to those deficiencies that really are the heart of the problem here, that really are causing us right now to be doing what we are doing? And, Marty, you may answer that, and I will stop.

Mr. BAILY. Well, I agree with you very much, Senator, that simply creating a single prudential regulator is not going to solve all our problems. The deficiencies of our system are greater than that, and there were a lot of private failures. We need to try to improve private incentives so that people do not get to play with other people's money and they take on the risk if the risk is there.

So I agree with you completely. This is not by any means going to solve all our problems. I think it does help, though, because it allows for the kind of consolidated regulation that can, if necessary, stand up to the big banks and make sure that they are following the right rules. It can respond, it has got the resources and the stature to respond to innovation because one of the problems with regulation is you are always sort of one step behind what the private market is trying to do. And we want to encourage that innovation, but at the same time, we do not want it to be in the direction of making things less safe.

So on the procyclicality side, we need to get rid of that. First of all, I think we need higher capital requirements so that in good

times there is plenty of capital, and in bad times we can sort of cushion that shock. So that needs to be part of the reform, too, is how we deal with cyclicalities, and there are some proposals there for so-called “contingent capital” or “convertible capital” that allow you to do that. So I think that should be an important part of the regulatory changes.

I just think also on the diversity of views, the way I would put it is that we need to make sure that our prudential regulator is accountable. I mean, there are a lot of people—again, I do not want to impugn anybody in particular, but some regulators made some very bad decisions in this process. And, you know, do they still have jobs? Maybe they should not.

We need to set up this structure in a way that preserves accountability whether it is a single prudential regulator or more than one.

Mr. CARNELL. Mr. Chairman, could I just add two quick points here?

Chairman DODD. Yes, certainly.

Mr. CARNELL. First, that the agency, Senator Corker, would incorporate a diversity of views because under what I am proposing it would have the Fed and the FDIC on its board. They would share in making policy. But even so, they are likely to have some disagreement with what comes out, and they will let you know about the disagreement. You would have more diversity within such a board than you would at most any independent agency and the rest of the Government.

Second, it is key in preventing crisis to look ahead and fix the roof while the sky is still blue, not to wait until the thunderstorm is brewing up.

Now, as for being procyclical—and I am building on that point—the Federal Reserve has actually tried to get rid of one of the existing two capital standards: the leverage limit. It has tried at least twice in the past 15 years. The existing capital standards were set in 1986 and 1992. We had years of enormous, unprecedented prosperity, record profits, and nothing was done to raise capital standards that had been set as the second best during a crisis.

So I think the existing system, including the Fed’s role in it, does not look good at all there.

Senator CORKER. Chairman Dodd, Senator Warner and I had a summit last night down at Johnny’s Half Shell, and——

Chairman DODD. Why weren’t we invited?

Senator CORKER. This whole issue, I think, of leverage is one that certainly we need to look at. You know, we actually urge people in this country to use leverage, but we penalize equity. And I hope that as we move through this, that is something that we will look at more closely.

I am sorry to take so much time.

Chairman DODD. Not at all.

Senator REED.

Senator REED. Thank you, Mr. Chairman. Thank you, gentlemen, very much for your testimony.

It seems that you are coalescing around the advice of the single consolidated regulator, and I just want to understand what the landscape will look like afterwards in simple terms.

There will be essentially two banking regulators—the FDIC and the Federal regulator. Is that your approach, Mr. Ludwig, focused on——

Mr. LUDWIG. Well, first there would be an——

Senator REED. No, I know the SEC is there and other things.

Mr. LUDWIG. But in terms of bank lending, you would have a highly professionalized institutional regulator, and to Senator Corker's concerns about procyclicality and also—I do not think it would be a super OCC.

One of the problems with the current alphabet soup is nobody is large enough, professional enough that there is really the kind of study, focus, or stature for these supervisors to be able to go head to head adequately on things like derivatives, emerging new capital structures, *et cetera*.

So I think that you would have two that would be at the Federal level close to supervision, but the Federal Reserve by nature, with its information gathering, study, and concern would be actively involved in thinking about these issues and prescribing solutions. And the new systemic council or systemic enterprise would also be very much a backstop to the banking supervision, as it would be a backstop to other regulatory issues throughout the Federal and State systems.

Senator REED. Well, let me just take a step further and focus on the point that Professor Baily made about the top-to-bottom bank holding company regulation. Would that be the Federal Reserve, or would that be the new——

Mr. LUDWIG. Oh, no, that absolutely has to be the new institutional supervisor. The notion, the stopping at the border, I think Mr. Baily said it really quite eloquently. Stopping at the border is absolutely pernicious, because if you have an examination issue and you really want to follow that through, you cannot basically have a situation where it migrates to another enterprise and the investigator cannot get to it, cannot see it, cannot enforce it. It must be holistic.

Senator REED. No, I accept that, but typically bank holding companies today are deposit-taking institutions, investment banks, proprietary traders, wealth management, *et cetera*. SEC has a responsibility, the CFTC. So just give me an idea of how this new Federal regulator who has got top-to-bottom responsibilities interacts with SEC, CFTC, and everybody else. That would have to be done, correct?

Mr. LUDWIG. Yes, it would, and to the point that there would not only be one. It would have the ability to investigate in detail and would have the responsibility to be an expert in all the financial issues that are important to the institution. But it would have, if you will, a colook, a coexamination, coconcerns from these other agencies.

Senator REED. You know, it goes to the point that was made, which is that when everyone is in charge, who is in charge? And we saw that so many times.

Mr. LUDWIG. But it would be primarily in charge, Senator.

Senator REED. So it would be very clear that this regulator would be the primary regulator of all these functions, even if they feel under the range of CFTC or SEC.

Mr. LUDWIG. In my view, yes.

Senator REED. OK.

Mr. BAILY. Yes, in my view, also.

Now, I do think the systemic regulator, whether it is a council or whether it is the Federal Reserve—I think myself I would prefer it to be the Federal Reserve, but whichever—does have, I think, the need to look across our whole financial sector because the prudential regulator is basically saying, Is this institution safe and sound? And we then have a consumer protection agency that is saying, “Is it behaving itself with respect to the consumer?” But we need to have a systemic regulator that says, “Do we have within our financial system a buildup of risky assets? Are we seeing a huge rise in risks being taken?”

Paul Volcker remarked that one of the clearest signs that a financial institution was going to get into trouble was that it was building a fancy new headquarters.

So I think, you know, if you see somebody making lots of money doing something that—that may be because they are very good, or it may be because they are taking a lot of risk.

Senator REED. Just a quick question. The FDIC is supported by its own fundraising activities, to put it mildly. One of our problems, frankly, is that we have underresourced at critical moments our bank regulators, our SEC. It goes to the point that you have all made. Where is the expertise? Where are the computer systems? How can you keep up with five Ph.D.s when you are, you know, a recent law school graduate?

So should we have this agency dedicated funding, not through the appropriations process?

Mr. LUDWIG. It should be dedicated funding by the industry. I do not think it needs to cost the taxpayer a nickel, and it ought to have, as is true today with the Federal Reserve, plenty of deep pockets to be able to do its job correctly.

Senator REED. If I may, one final question. We have talked about one Federal regulator for Federal institutions. Should there be one Federal charter? Should we eliminate the Federal thrift charter, the Federal savings bank charter, *et cetera*?

Mr. LUDWIG. I do not think you need to do that. I think the issue of the Federal thrift charter is an issue that is fundamentally steeped in the housing policy of the United States. That is, do we want to foster housing as a special goal. That decision need not be made if you have a single consolidated institutional supervisor.

Senator REED. Thank you, gentlemen.

Mr. BAILY. My inclination might be to create a single charter for these Federal institutions. I do not think I will fall on my sword on that one, but that would be my inclination.

And to go back to Senator Corker’s point, we do have a lot of provisions in our tax law and our laws to promote homeownership, and I think that is a good idea. I think homeownership is a good thing. But as part of that, we also promote borrowing. I mean, we really do, and maybe we have gone too far in that direction.

Senator REED. Just one final point. Professor Baily, you made, I think, a very cute observation. Most of the decisions where to stick these functions were a function of regulatory preference and tax

law. And as we sort of look at reforming our regulatory system, I do not think we can be sort of oblivious to tax provisions that—

Mr. BAILY. Absolutely.

Senator REED. —can form behavior more than our regulators. And as we go forward systematically, I think we really have to look at the Tax Code as well as the Federal regulations and Federal banking law.

Mr. BAILY. Absolutely.

Chairman DODD. That is very good. And good suggestions, by the way.

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. I appreciate the panel. It is a little challenging. You have raised a lot of the issues I was hoping to. I guess that is the challenge of being far down the table here. But I will try to re-ask the same questions perhaps.

As somebody who has been an advocate, as I think some of the panel knows, of a single end-to-end regulator, you know, I want to go back to what the Chairman raised around some of the, I think, legitimate concerns that the community banks and smaller banks have offered, and I would be happy to have any member of the panel comment on this.

I do think there is—the notion of a separate division makes some sense, but in any large organization is not the bias going to be toward the larger institutions? Is the best personnel going to want to seek out serving the larger institutions? And could you—what other protections could we ensure to make sure that the smaller banks do not get the short end of the stick? And I believe a couple of you mentioned—Martin, you mentioned as well that you could have different regulatory standards. And I guess I would like you to touch a little bit on that. How do we make sure that if we were to go with the single end-to-end regulator you would not be imposing the same overly burdensome set of regulations on a very small community-based bank that you might be on a major bank holding company?

Mr. LUDWIG. First, I would say—

Mr. BAILY. Go ahead.

Mr. LUDWIG. Oh, I am sorry, Martin.

Mr. BAILY. No, no. Go ahead. No, please, you start, and it gives me more time to think.

Mr. LUDWIG. First, I would say, Senator, that I do think that it makes sense to enact protections so that community banks—one, it is a comfort that they are protected in terms of having a simplified, specialized regulatory approach that best suits their needs.

Having said that, my own experience at the OCC, where there are—in my day, I think over 2,000 community banks. It may be actually true today. I used the word a thousand—is that you do have the quality people at the agency devoting their attention to the community banking sector. Indeed, one of the advantages of having a consolidated regulator is, as people come up, you have similar talent available for both sides of the aisle, and you find—today, for example, the gentleman in charge of small bank supervision at the OCC was a large bank supervisor during his time, and he is one of the most talented people there. I think you will find that interplay.

The danger, I think, works the other way, that if you separate the two, you will only have second-class supervisors at the smaller institutions as opposed to having the cross-fertilization you do with the larger institutions.

The other thing I think worth pointing out is just because you are smaller or larger does not necessarily mean you are more complex or less complex. Some of the smaller institutions by choice get involved in fairly complex issues, and there is going to be a tendency as we go into the future, because of the Internet, because of technology, because of the structured products available, that smaller institutions will indeed get involved with these more complex activities, and the supervisor not only needs to supervise that adequately, A, but it also needs to have the sophistication to help the small bank with these products. I think it is perfect doable, and I think you will just have a higher-quality supervision generally.

One cannot also overstate in this whole discussion the pernicious nature of regulatory arbitrage. I know that is not your question. But both having—

Senator WARNER. That was my next question.

Mr. LUDWIG. As a supervisor, whether it is your examiners that get threatened by the offhand, intended remark of some bad actor banks saying, look, we do not have to put up with this, we can move to another regulator, and how that—even if you are being tough at headquarters to do the right thing, how that can degrade the quality of supervision generally. That is not just theoretical, but if you have to do it every day, it is real.

Senator WARNER. Before Marty answers, I do think that is a valid point, that we sometimes look at the arbitrage in terms of banks that have actually switched charters and some of those that were very much engaged in the crisis, but I think that is a very important point you raised, that if simply the implied threat of switching may end up utilizing that regulatory arbitrage and consequently not having the—

Mr. LUDWIG. When I was Comptroller, Senator, I had bankers in my office when they were unhappy threaten me, and my examiners, I know, had to live it in the field during their time, and I think most folks who have experienced that would have that, and that is really—it degrades the quality of supervision.

Mr. BAILY. I would like to reinforce that view, and I think it is why—you know, in general, I am a big fan of competition as a means of making things more efficient and creating diversity, but competition among regulators can have this downside of regulatory arbitrage.

Let me comment on the point about maybe different requirements. You know, Senator Dodd mentioned that it may be difficult politically. That shouldn't govern what decision is made. It may be difficult politically to do consolidation, so I think one thing that needs to be sure to be in the legislation is that we satisfy the community banks that we are looking after them, because otherwise, there is going to be a lot of resistance to this legislation.

And obviously, as individuals, we all like the devil we know, so to speak, and people want to hold on to the regulator they have, and that is another reason they are resistant to this consolidation. So I think it is very important that we carve out for the community

banks a sense that they will be looked after, they won't be subject to burdensome regulations.

On the other end of the scale, for the——

Senator WARNER. Can you speak to that for a moment?

Mr. BAILY. Yes——

Senator WARNER. I know my time is running out, but just how could we put in place, or what kind of guidelines so that you wouldn't perhaps have the same level of burdensome regulation for a small community bank *versus* a major bank holding company?

Mr. BAILY. Well, I think I would defer to my colleagues on the details. The part of it that I think I would like to comment on is the capital requirements. I actually don't like the idea of designating Tier 1 institutions. I don't like the idea of trying to cap the size of institutions. But clearly, we need to do something so that we don't end up bailing out these great big institutions.

So having a sort of sliding scale, that the bigger you are or the more interconnected you are or depending on the kind of activity you do, that the capital requirements and potentially the extent of supervision—how often, the nature, the information you have to report, how frequently you have to report it—those kinds of things could increase as an institution becomes larger or more important to the system, and I think that is also a way of taking some of the burden off of the community banks.

Mr. LUDWIG. If I might, Senator, I would reserve the right to come back to the Committee with a list of suggestions, because I come from a small town myself, and I am a huge believer in community banks. I think it is one of the great benefits here in the United States, one of the great forces for good and innovation, and I think the consolidated supervisor at the end of the day will do more to support community banking than the current system.

Senator WARNER. And it may even get down to not simply capital requirements, but literally forms and volume of forms they have to——

Mr. LUDWIG. Right. Right.

Senator WARNER. I know my time is expiring. One final point, Mr. Chairman. I won't ask the question, but I just want to follow up on Senator Reed's comments, and again, it is part of what the panel has made mention of. When we have seen these kind of closed doors take place that you have had before this panel, clearly the most visible example of that with the enormous scandal of Mr. Madoff and the fact that regulators were not able to go beyond their prescribed jurisdiction, and that clearly—thank goodness we have not had that same kind of travesty take place in the banking system, but this fact that we have got one focus looking at the bank holding company level, another looking at the bank depository piece, could create that same kind of—and as Senator Reed mentioned, the securities piece—failing to have that single end-to-end regulator that can look at the whole bank holding company and all of its operations would prevent that.

Chairman DODD. Let me just, before I turn to Senator Merkley, it is a related question. Maybe Mark asked this in a way. Maybe he addressed it when I stepped out for a second, and that is on the issue of assessments, for instance. I don't know if you raised that or not, but do you see some? Because, clearly, if I am sitting back

as a community banker, I am going, well, wait, yes, it is nice to have the division in all of this, but am I going to be assessed? I presume you wouldn't be, but I wonder if you would address that question, because clearly it is one of the concerns I would have. Could you address the issue of assessments?

Mr. BAILY. I think you must have a system that is counter-cyclical, while our current system is procyclical, and one that doesn't penalize the best community banks, which the current system does, and pay for the sins of the bad ones. So the system of assessments that funds this agency has to be one that takes into account not increasing the assessment for community banks and certainly not increasing the assessment for any banks in the storm, and I think that is achievable in terms of the way the institution is funded.

Chairman DODD. Legislatively, in some way, though, right?

Mr. BAILY. Yes, sir. So, for example, the reserves on deposit at the Fed are currently used to fund the Federal Reserve's regulatory activities, I believe. One could use the reserves similarly to fund the regulatory activities of the new consolidated supervisor, if that was Congress's predilection, or part of it could be used to make sure that the community banks had a particularly fair opportunity to pay what was appropriate for them. I think there is a lot of plasticity in the way one could construct this to be fair and counter-cyclical in terms of the funding mechanism.

Chairman DODD. Thank you very much.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you all for your testimony.

When Mr. Bernanke was before us, he made an argument that the Fed should be the principal entity both for monetary policy, prudential policy, consumer policy, and systemic risk—everything—

[Laughter.]

Senator MERKLEY. and I raised my concern that some of these would be in conflict with each other and he made the best case he could that they fit very well together.

I think the article that was in the *Washington Post* on Sunday that pointed out some of the failure to address consumer issues over a significant period of time in many ways goes to my concerns. I believe that what I am hearing from you all is summed up in part by what is in the GAO report, that the twin peaks model is viewed as advantageous by some because the two principle objectives of financial regulation, systemic protection and consumer protection, are fundamentally in conflict, and putting these objectives in different agencies institutionalizes the distinction and ensures that each agency focuses on a particular objective. It goes on. But does that fundamentally underlie the perspective that all four of you are bringing to the table?

Mr. BAILY. Well, I think—I am an admirer of Ben Bernanke. I am not a close friend of his, but I have known him for a long time and I admire the way he handled this crisis. As I said in my testimony, I don't think the Fed—I am also an admirer of Alan Greenspan, who is a friend of mine, and I don't think—leading up to this crisis, I think they made some very substantial mistakes when they

didn't give enough consumer protection and they didn't react to some of the bad lending that was going on. So I think there were certainly a lot of mistakes that were made prior to this crisis that would have mitigated it.

So, you know, I understand why, obviously, the Fed wants to hold on to the authorities it has, but I think what we are suggesting is that you take away the prudential regulation part, because that may be in conflict. You make sure that it still has access to the information it needs, but it is no longer the prudential regulator.

I think the thing that the Federal Reserve has done well is monetary policy, not that they haven't made any mistakes, but if you look over the last, oh, 20, 30 years, I think they have done a good job, and typically when you pick people to serve on the Fed, you tend to pick economists or people with expertise in monetary policy, and that is the thing they should do, and I think they should also, since monetary policy is key to the stability of the economy, I think they should also be concerned with systemic stability.

But I don't see why—they certainly haven't done a great job on prudential regulation and I don't see—what is the point of the Chairman of the Federal Reserve sitting around worrying about details of credit card regulation? That is what he is doing right now, and I think that is a mistake and not a good use of his time.

Senator MERKLEY. Does anyone else want to comment?

Mr. CARNELL. Yes. A couple of things, Senator Merkley, if I could. First, the Federal Reserve argument that it needs to be a primary Federal bank regulator to do its monetary policy responsibilities are just not credible, based on facts at several levels. First, right now, the Federal Reserve only has supervisory responsibility for 13 percent of FDIC-insured assets and 10 percent of FDIC-insured institutions, so it is not a significant proportion at all.

And then on top of that, our whole commercial banking system only accounts for 18 percent of credit market assets. Gone are the days when banks held 50 percent of those assets, as would have been true when I was born. There is just a big change in the growth of other financial markets and it is just out of touch with reality for someone to suggest that that Fed connection to being a primary Federal bank regulator is essential.

Senator MERKLEY. I want to get into some other questions before I run out of time here, but Mr. Carnell, to follow up, you made a comment in regard to bank holding companies, that they exist to allow banks to get into businesses that are, and I am not sure if I caught this quite right, but incompatible with banking or very distinct from banking. Should we be eliminating bank holding companies? I mean, do they serve a—what purpose do they serve—

Mr. CARNELL. Well, just so—

Senator MERKLEY. —more risk than value?

Mr. CARNELL. I don't think we need to eliminate them, but I do think our system has put much too much emphasis on them. I think our focus in banking policy should be on what can banks do and how should they go about doing it.

I wouldn't want to leave the impression that bank holding companies had this role as letting do something nefarious. I mean, we

are talking about things like opening an office in the next county, opening a bank in the next State. These were things that restrictive laws of 50 years ago didn't allow. And then getting into non-banking activities, many of which are not allowed in the bank or Congress has passed a law saying they could be in the same corporate family.

So it is not that the activities were inherently problematic, but it is that we have this enormous growth of holding company regulation that is really unrelated to any real need other than the fact that we sort of built it up in these loophole-based ways.

Mr. LUDWIG. If I might, Senator, go a little farther, I would say that the comment—I forget whether it was Senator Corker or someone made, that, in fact, what happens when you have to make a decision at the corporate level, you ultimately decide what box to put it in for capital reasons or tax reasons, *et cetera*, and what happens then at the supervisory level—so I find something wrong in the bank. I can't go to that other entity. That other entity is not being supervised, and in fact, if you look at this current debacle, a great deal of the problem in the larger financial institutions was not in the technical bank. The bank was infected by it. It was actually in the nonbank affiliates that were hard to get to and it was hard to look at the animal as a whole. And if you are really going to be an effective supervisor—after all, everybody has the same interest, a healthier institution—you have got to do the whole piece.

Senator MERKLEY. Thank you all. I am over my time. I will just close by echoing concerns about the community banks and also about our credit union system, where they have rules that have constrained their risk, not using prepayment penalties, having interest rate caps, and so forth. They are a little nervous about being rolled into a system with an unfamiliar regulator and perhaps paying fees disproportionate to the risk they impose on the system, and so our community banks and our credit unions may—are a little disturbed that they might not have been so much of the problem but may get rolled into a disadvantageous set of rules, and so of great interest. Thank you.

Chairman DODD. One of these things that is going to be important for us, this is not being punitive. I think that is one of the things we are getting into, this notion that because some have been good actors and bad actors, I think we have some history of that. So I think it is really important as we look at all of this, this is not to punish some or discipline some, but rather to try to think in 21st century architectural terms. How do we create an architecture and a structure that makes sense in all of this?

And the only thing I was getting at on the assessment issue, because I think putting aside the question of who was responsible for what, just given the magnitude and size and complexity of institutions, I mean, the idea that you would level sort of the same assessments across the board because you have one regulator, to me would be offensive. I mean, you have got to clearly make some distinguishing features. But I hope we can stay away from the punitive quality here as we look at all of this.

We can go back and examine, how did we get here and what we are trying to do, and I think all of us agree that, in part, it was this patchwork out there that contributed, certainly, among other

things. It is not the only thing. I think somebody made that point, that there are a lot of issues we need to look at. This is one of one.

And it isn't going to solve everything, either. I think Bob Corker made the point, and I agree with him on this, is the assumption that if you solve this, you would solve the problem, I think would be false.

But clearly I want to get away—because I think you can see that developing, that argument that somehow we are laying—we are blaming institutions by putting them in this. That is not the argument at all. The question is whether or not this makes sense.

Let me raise one other question I have for you, and then I will see if anyone has interest in a second round. I wonder if you agree with the Administration's proposal regarding the systemically important financial companies that have a parent or significant affiliate engaged in commercial activities, whether they should be regulated as a bank holding company and forced to divest commercial activities. This is a big issue that is going to be before us. It sort of follows on with Jeff's question, I think, that he raised. Does anyone want to jump into this one? Professor, you sound like you have got some strong views on this, so—

Mr. CARNELL. I do. I think this is a very troublesome aspect of the Administration's proposal. I should emphasize that I am troubled mainly on its use of political capital. I don't know that—I don't think the substantive stakes are very large here. I will make that more clear in a moment.

Go back to the point I made earlier about how bank holding company regulation as a really big deal is unique to the United States. It is a historical quirk of our system. It is something the Federal Reserve got hold of in a context where the Congressional objectives were completely different from what we have now and the Fed was able to expand its authority and make it into a very big deal.

Let me actually just make that a bit more clear. The bank holding—there is something in my written statement about this, but the Bank Holding Company Act was passed in 1956 in a populist effort to limit bigness and also to split up some affiliations, like Bank of America and TransAmerica were affiliated at the time. But basically we had—Chairman Wright Patman of the House Banking Committee believed that everything was too big, including \$100 million banks, and so he responded with the Bank Holding Company Act. He got trade association support for people who were concerned about banks getting into their business.

We are not talking about something that was a safety and soundness statute in its origin. It was a kind of populist antimonopoly statute in its origin. We see safety and soundness come in as a criterion in 1970 as a basis for exceptions on some things. But this was not originally a safety and soundness statute. It was not a statute relating to bank policy. And yet it becomes what my old boss, Jerry Hawk, Under Secretary of the Treasury, said, a matter of theology, where there are people invested in a certain kind of outcome here.

And so what they are wanting to do, then, is to conform the existing nonfinancial owners of financial institutions to sort of a very pure version of how they would like things to come out. Now, in fact, nonfinancial institution ownership has saved the taxpayers

money. Ford Motor Company put about \$1 billion, as I recall, into a thrift institution that had acquired trouble. So there has been positive results. I don't think there have been significant negative results. And this ownership, like General Electric and so forth, was not a source of the current crisis.

So the idea of making a big deal out of this is sort of like, as we have seen from some quarters, is sort of like trying to protect us from the Mexican mafia by building a wall on the Canadian border. It is just not related to the major problems.

Chairman DODD. Well, thank you for that observation. I want to make the point, I just mentioned to Senator Merkley as he was walking out, I heard him say credit unions. Credit unions are not part of this consideration at all. We are talking about banks. And before we start getting inundated with e-mails and messages from across the country, credit unions, you are OK on this.

[Laughter.]

Chairman DODD. Let the word go forth from all of this.

Senator Corker, any—

Senator CORKER. No. I think you have just given evidence as to where the real political clout is.

[Laughter.]

Senator CORKER. I referred earlier to sort of a super-OCC, and I realize it is sort of that, what you are proposing. As we have looked at the resolution mechanisms that need to be in place so that we don't have the same kind of problem, I think we all understand part of the reason we had the problems we had was there was no resolution mechanism for highly complex bank holding entities and one of the only solutions was to prop them up artificially.

So the OCC has argued strongly to keep in place the ability to use taxpayer monies to prop up institutions that fail. The FDIC, on the other hand, has argued strongly against that. I happen to have fallen on their side of the equation and think that having any institution that is too big to fail creates tremendous problems, and I really appreciate what Paul Volcker has said about that recently.

But hand-in-hand with this is the notion of how we resolve—in other words, we have the regulator—how we resolve that. You all have already made a great case for this type of arrangement that you want to have. I don't think there is any point in going down that path anymore. I understand what it is you would like to see happen. But what should we do as it relates to a resolution mechanism and how should that be set up?

Mr. LUDWIG. Well, Senator Corker, I couldn't agree with you more that resolving the largest institutions is a critical issue and I am not in favor of propping them up. That is, if we don't resolve them, we basically create two problems. One is we have public utilities if we don't have an ability to resolve them. And we also disadvantage the community and regional institutions.

Rather, this whole structure ought to be one that creates sufficient stability and focuses in a professional way on proper supervision so as to minimize burden and increase the ability of all these institutions to support the economy of the United States. And where one of these institutions is not doing its job correctly and it gets into problems, we have to have a private sector component here—this is really a private sector activity—where it fails, and we

have to have the ability to fail it without creating a systemic crisis. If we don't have that, I think we also have the danger that these largest institutions end up controlling the economy and the Governmental mechanism, not *vice-versa*.

Mr. BAILY. Can I throw in a comment? I think Gene is absolutely right and you are right. We don't want to have institutions that are too big to fail. We want to be able to have a mechanism by which they can go bankrupt when they make bad decisions. Otherwise, this is not a good system at all. But realistically, I mean, if an airline goes into bankruptcy, you can still have the planes fly, or if a railroad goes into bankruptcy, you can still have the trains go on the tracks. The trouble with a financial institution is that it may get to a certain point where it really can't function without some kind of funding or some kind of support to keep it going.

Now, to some extent, that was the justification for giving money to General Motors. You needed money for the suppliers, and I don't want to get into that case which I don't know the ins and outs of.

But clearly, we need a mechanism, whether it is a bankruptcy or a resolution mechanism, that has a certain amount of money available to make sure that you don't just close the doors and people can't get at their money. Now, what is in the Treasury proposal is a sort of open-ended checkbook that somebody can write a check for any amount to prop up an institution. So I think that is—I don't agree with that. I think that Treasury proposal is too open-ended, and I think the House and the Senate need to make sure taxpayers are protected and that they have a control over the purse.

But I don't think we can, at the same time, just say, no, we are never going to put taxpayer money in again, because the fact of the matter is we will come into another financial crisis and we will end up putting in a lot of money, and it is better to have a resolution mechanism or a special bankruptcy court that has the resources to let this thing down gently, although letting it down.

Mr. CARNELL. Senator, be wary of anyone who puts a lot of stress on the notion that we need a new resolution mechanism. By and large, we had the resolution mechanisms that we needed. I could be a little more specific about that, but just to put it in the perspective.

There certainly are some things that could be helpful here, but basically, we had the mechanisms. There were two problems. First, the system had been allowed to go in the direction of internal weakness to such a degree that problems piled up and happened quickly. But mainly—

Senator CORKER. And how did that happen, by the way?

Mr. CARNELL. Well, I mean, we are talking about a decade in which—or more specifically, from about 2002 to 2007 in which market participants became increasingly complacent about credit risk and where regulators were not taking the opportunity to strengthen things like capital standards while the sky was blue and the sun was shining, take advantage of that time to build bank capital up. Those would be some examples of things that could have been done in the context.

But the key thing is that most of the laws we needed were already in place, and in the case of something that is a bank or

thrift, the Federal Deposit Insurance Act is the model for the world in terms of doing resolution, and——

Senator CORKER. And we used it, but what about in the other examples of how they kind of—I won't name the entities, but our largest entities in the country, what about in those cases?

Mr. CARNELL. Well, if you——

Senator CORKER. What type of mechanisms existed that we didn't use?

Mr. CARNELL. Well, I should emphasize that many of the largest entities in the country are bank holding companies where the biggest part of the firm is the bank. So the law was there available for that. Now, with a bank holding company——

Senator CORKER. Or the FDIC to come into the bank component itself.

Mr. CARNELL. That is correct, and let me just emphasize that this does not require—it certainly doesn't require a pot of taxpayer money and it doesn't necessarily—FDIC money is not the only thing that is available, because you can—the FDIC needs to satisfy insured deposits. But other creditors can have a haircut applied to their claims and you close the bank one day and it opens the next business day with a new charter, but the same tellers and so forth there.

Now, as for the nonbank part of organizations, we do have the bankruptcy courts. There are some changes that would make sense for bankruptcy courts dealing with nonbank financial institutions, for example, to make sure that you can't shop for the court that you think is best, say shop between New York and Delaware or something like that, to make sure that these cases go to judges who have some expertise and some other things to expedite that. But basically, the law is there.

Senator CORKER. I would like for you, if you would, to schedule some time to come in and talk about some of the tweaks on the bankruptcy side. And again, I just want to point out that in many ways on this regulatory piece, we are looking at sort of rearranging the deck chairs, and I think the suggestions that each of you have made have been very helpful, but even after you make those changes, it is that lack of—it is that procyclical thinking that drove us to where we were. The sun was shining and so we were continuing to do more and more instead of reserving up more. And I still haven't heard of a way—it seems like to me that what we are going to do is create sort of a super-regulatory entity, but we still haven't yet figured out a way to cause them to actually not be procyclical. So again——

Mr. CARNELL. If I could come back to you on that one, Senator, it is a very difficult challenge, and I do not mean to suggest that there is any simple solution to the problem that you—the challenge you pose there.

I do emphasize in my testimony the importance of looking at the incentives that regulators have, because the fact is: bank regulators had the tools that they needed, but they did not take action that they could have here. Part of it is a foresight problem, but part of it is also an incentive problem. That is, if you look at it from the standpoint of the particular people making the decisions, what makes sense from their standpoint?

Now, in a four-regulator system where there is squabbling over turf, where there is competition for regulatory clientele, it is tougher to look ahead—if you are the person who is looking ahead and said—to take the example—let us go for higher capital standards now, let us raise the standard in terms of your exposure to systemic risk from other institutions. If you look ahead and you are doing the thing that is not considered obvious at the time, you are more open to criticism. And in a multiregulator system, the friction among regulators provides something of a disincentive there. On top of that, where you need to do joint rulemaking with regulators—and that is a requirement under various laws—you know, you run into other ones who say, “If it ain’t broke, don’t fix it.”

Mr. BAILY. Since you want people to be wary of folks like me that think—

Mr. CARNELL. I do not mean you.

Mr. BAILY. Well, you should, because I think you need to have a certain amount of money available. However good a system you set up, a big financial institution is going to get into trouble at some point in the future. That has always been true, and I suspect it is going to be true again. We can improve regulation as much as we like, but somewhere somebody is going to get into trouble again. And I think we need to make sure that we have a mechanism, whether it is—I think it should be a special bankruptcy court. I do not think you can just pick any judge. I mean, this has to be a judge with special expertise. Or you have a resolution mechanism, and there has to be a way—you know, this is not just FDIC, because this is not just banks. It is financial institutions more generally. And we have to have a way in which we can keep them operating and that they do not bring the rest of the system down while we are doing it. And if we do not set up that now, then you are going to end up—taxpayers are going to cost a lot of money down the road.

Mr. LUDWIG. Two points, Senator. One is that these systemic problems are really, by and large, governmental problems. They are not institutional problems. So when you say who is going to be looking out, one of the reasons you want to have somebody with a systemic responsibility for looking for systemic problems—*i.e.*, bubbles—that is independent is because if you look historically, it has really been governmental problems into which institutions are dragged, by and large.

The second thing is the point you made and the point that Rick made about a single consolidated regulator being less given to arbitrage and, therefore, more likely to be conservative. To some degree, the proof of the pudding is in Canada and Australia. In both those systems, they are both English-speaking countries with consolidated prudential supervisors, and that is all they did. And in both systems, they were quite conservative as regulators in terms of their institutions.

Now, I just came back from Canada. I was up a couple weeks ago and spent some time with their finance minister and their head of the central bank and their bankers. And they will all say that their supervisor was a restraining force on them getting into a lot of the problems that our institutions got into.

Senator REED [presiding]. Senator Warner.

Senator WARNER. Mr. Chairman, I will not ask a question. I would just like to make a request to the panel, because it is clear that the panel has got a lot of ideas here.

As I think I said earlier, I would love to see more specificity about how we can ensure community banks, smaller banks, are inside a single end-to-end regulator, from assessments to less regulatory, less paperwork. What are the protections we could give beyond division, number one?

Number two, Senator Corker and I believe that there needs to be expanded resolution authority at least to bank holding companies, with the FDIC, and the FDIC has raised—and I know you have addressed today, but has raised the concern that if they were—if we took away their prudential supervision, would back-up supervision be enough to have them have their pulse on the status of all of the institutions that they might cover in this expanded jurisdiction. So I would love to have some specific suggestions on how we could address that concern.

And then, third, obviously, you know, the Federal Reserve will make the point that, as lender of last resort, they still need to keep their hands in this pie in terms of at least with these larger institutions on the bank holding companies. And I think you have made some very—the whole panel has made a number of valid points about the bank holding companies, but I would love—and, again, Martin, you made the comment about the fact that FDIC and the Fed would be on the board. But what are other ways that we could ensure that the Fed, as lender of last resort, would not lose the expertise that they have?

Thank you, Mr. Chairman.

Senator REED. Thank you very much, gentlemen. I just have one or two quick questions since I have got the opportunity with this panel, which is rare.

Going back to the landscape after we adopt a single regulator, at least hypothetically, should the Federal Reserve continue to have any regulatory authority with respect to State member banks if that is all they are doing in the regulatory sphere? Mr. Ludwig.

Mr. LUDWIG. I would not think so, Senator. I think there is huge advantage to having, just like companies, entities that do things that they do well and focus on them. I think it is better for oversight for the Congress. I think it is better for the agencies themselves. And I think to Martin Baily's excellent point, monetary policy is so essential in central banking functions. Do we really want our Chairman of the Federal Reserve sitting around thinking about either consumer rules or bank supervision rules? Which are not unimportant, but how much can you do in a day?

I think one of the problems we have with CEOs generally is how much can you actually accomplish in a day, and I think that is an enterprise that they should give up.

Senator REED. Another general question is that this is an opportunity, obviously, and a necessity to look across the board in terms of the Federal regulatory structure, and I think not just in concept of how you regulate banks, but the structure itself of the Federal Reserve. As we cut back, presumably, some of their responsibilities, does their present structure still need to remain the same with re-

gional banks located sort of because the way America was in 1930, not 2010? Does anyone have any comments?

Mr. CARNELL. I would not try to defend the location of Federal Reserve banks, including, you know, the old thing about why are there two in Missouri. But I do think the Federal Reserve banks play a valuable role in Federal Reserve policymaking. That is, they are not just regional offices that receive top-down directives from Washington. And I think in monetary policy and in a great many other things, they provide a diversity of perspective that is desirable.

I would note, by the way, that where a significant proportion of supervisory personnel are currently located in Reserve banks, that same space could be used, if desired, by employees of the new agency, and you would still have, you know, interaction of proximity there. So I would keep the Reserve banks. I would encourage cross-fertilization like that. I do not think—

Mr. LUDWIG. I think that is an excellent—I mean, a consolidated supervisor does not mean that everything should be in Washington. And, indeed, with the majority of the banks being located everywhere, you would assume there would be substantial regional offices and duty stations really all over the place. But the advantage of being able to filter it back and have cross-fertilization I think is huge.

Mr. BAILY. I agree.

Senator REED. Let me ask you if there is a final comment by any of the panelists that you would like to make before I thank you very much and—yes?

Mr. CARNELL. Actually, I would like to say, if I could, some words in favor of a consumer financial protection agency. I support creating a new independent agency. As I would propose, it would have full responsibility for writing rules implementing consumer protection legislation, financial consumer legislation. And I would also agree with the Administration that it should have primary enforcement authority over nonbank lenders.

Now, I differ with the Administration on a couple of points. I think it should have only back-up enforcement authority over FDIC-insured banks and their affiliates. I think that is enough. I think that will do the job. And I also do not support slashing the preemptive effect of the National Bank Act. The State regulators had primary responsibility for dealing with nonbank lenders that were the epicenter of predatory lending. They did a poor job, and yet what they talk about is national bank preemption, which was not the practical problem there.

On top of that, I point out that the Supreme Court issued a major decision earlier this year, *Cuomo v. Clearing House*, that cut back on some of the preemptive claims made for the National Bank Act. So I do not think there is a need for action in the preemption area, certainly not what the Administration has proposed. But the agency is a good idea.

Senator REED. Thank you, gentlemen, very much for this excellent testimony, and thank you very much.

Mr. BAILY. Thank you for having us.

[Whereupon, at 3:55 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

This afternoon, we will examine how best to ensure the strength and security of our banking system. I would like to thank our witnesses for returning to share your expertise after the last hearing was postponed.

Today, we have a convoluted system of bank regulators created by historical accident. Experts agree that nobody would have designed a system that worked like this. For over 60 years, Administrations of both parties, members of Congress, commissions, and scholars have proposed streamlining this irrational system.

Last week I suggested further consolidation of bank regulators would make a lot of sense. We could combine the Office of the Comptroller of the Currency and the Office of Thrift Supervision while transferring bank supervision authorities from the Federal Deposit Insurance Corporation and the Federal Reserve, leaving them to focus on their core functions.

Since that time, I have heard from many who have argued that I should not push for a single bank regulator. The most common argument is not that it's a bad idea—it's that consolidation is too politically difficult. That argument doesn't work for me.

Just look what the *status quo* has given us. In the last year some of our biggest banks needed billions of dollars of taxpayer money to prop them up, and dozens of smaller banks have failed outright.

It's clear that we need to end charter shopping, where institutions look around for the regulator that will go easiest on them.

It's clear that we must eliminate the overlaps, redundancies, and additional red tape created by the current alphabet soup of regulators.

We don't need a super-regulator with many missions, but a single Federal bank regulator whose sole focus is the safe and sound operation of the Nation's banks. A single operator would ensure accountability and end the frustrating pass the buck excuses we've been faced with.

We need to preserve our dual banking system. State banks have been a source of innovation and a source of strength in their communities. A single Federal bank regulator can work with the 50 State bank regulators.

Any plan to consolidate bank regulators would have to ensure community banks are treated appropriately. Community banks did not cause this crisis and they should not have to bear the cost or burden of increased regulation necessitated by others.

Regulation should be based on risk—community banks do not present the same type of supervisory challenges their large counterparts do.

But we need to get this right, which is why you are all here today. I am working with Senator Shelby and my colleagues on the Committee to find consensus as we craft this incredibly important bill.

PREPARED STATEMENT OF EUGENE A. LUDWIG

CHIEF EXECUTIVE OFFICER, PROMONTORY FINANCIAL GROUP, LLC

SEPTEMBER 29, 2009

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 1 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 nonmember 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 policymaking 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 nonbank 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 consolidated 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 and 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 backup 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 profes-

sionals. It is a reflection of our dysfunctional, alphabet soup supervisory structure.

- *No Evidence That Consolidated Supervision Works.* Sixth, some have claimed that because the U.K.'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 U.K. 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 U.K. 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 nonbanks, 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 well-being 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 nonbank 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 Govern-

ment 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 Task.* 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 policies 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 crisis 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 and 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-a-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 unregulated 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.

PREPARED STATEMENT OF MARTIN N. BAILY

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SEPTEMBER 29, 2009

Thank you Chairman Dodd, Ranking Member Shelby, and Members of the Committee for asking me to discuss with you the reform of Federal regulation of financial institutions.¹

I would like to share with the Committee my thoughts on consolidation of the Federal financial regulatory agencies and what it would take to make them successful in the future. However, this is part of a larger puzzle—the reorganization of Federal financial regulation generally and, in some respects, it is difficult to discuss the narrower topic without examining the broader context. I will therefore also say something about possible complementary changes in the roles of the Federal Reserve, the SEC and the proposed CFPB.

A summary of my testimony today is as follows:

- The best framework to guide current reform efforts is an objectives approach that divides regulation up into microprudential, macroprudential, and conduct of business regulation.
- The quality of regulation must be improved regardless of where it is done. Regulatory and supervisory agencies must have better qualified, better trained and

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better paid staff with clear objectives to improve safety and soundness and encourage innovation. Regulatory personnel must be accountable for their actions.

- A single Federal microprudential regulator should be created combining the regulatory and supervisory functions currently carried out at the Fed, the OCC, the OTS, the SEC, and the FDIC. This regulator should partner closely with State regulators to ensure the safety and soundness of State chartered financial institutions, sharing supervisory authority.
- The U.S. needs effective conduct of business regulation. The SEC is currently charged with protecting shareholders and the integrity of markets and must improve its performance in this area. In my judgment, the SEC should also create a new division within the agency to protect consumers, that is to say, it would add a CFPB division and become the consolidated conduct of business regulator. Although my first choice is for a single conduct of business regulator, a well-designed standalone CFPB could also be effective.
- The Fed should be the systemic risk monitor with some additional regulatory power to adjust lending standards. In this it should work with a Financial Services Oversight Council, as has been proposed by the Treasury.

The Objectives Approach to Regulation

I support an objectives-based approach to regulation.

The Blueprint for financial reform prepared by the Paulson Treasury proposed a system of objectives-based regulation, an approach that is the basis for successful regulation in Australia and other countries overseas. The White Paper prepared by the Geithner Treasury did not use the same terminology, but it is clear from the structure of the paper that their framework is an objectives-based one, as they lay out the different elements of regulatory reform that should be covered. However, they do not follow through the logic of this approach to suggest a major reorganization of regulatory responsibilities.

There are three major objectives of regulation:

- First is the microprudential objective of making sure that individual institutions are safe and sound. That requires the traditional kind of regulation and supervision—albeit of improved quality.
- Second is the macroprudential objective of making sure that whole financial sector retains its balance and does not become unstable. That means someone has to warn about the build up of risk across several institutions and take regulatory actions to restrain lending used to purchase assets whose prices are creating a speculative bubble.
- Third is the conduct of business objective. That means watching out for the interests of consumers and investors, whether they are small shareholders in public companies or households deciding whether to take out a mortgage or use a credit card.

An objectives-based approach to regulation assigns responsibilities for these three objectives to different agencies. The result is clear accountability, concentration of expertise, and no gaps in coverage of the financial services industry—even as its structure changes and new products, processes and institutional types emerge. No other way of organizing regulation meets these important criteria while avoiding an undue concentration of power that a single overarching financial services regulator would involve.² The main focus of this testimony will be to make the case for a single microprudential regulator, something I believe would enhance the stability of the financial sector. Having a single microprudential regulator is not a new idea. In 1993, the Clinton Administration and the Paulson Blueprint in 2008 proposed the same thing.

It is important to remember that how we organize regulation is not an end in itself. Our plan must meet the three objectives efficiently and effectively, while avoiding over-regulation. In addition for objectives-based regulation to work, it is essential to use the power of the market to enhance stability. Many of the problems behind the recent crisis—executive and trader compensation, excessive risk taking, obscure transaction terms, poor methodologies, and conflicts of interest—could have been caught by the market with clearer, more timely and more complete disclosures. It will never be possible to have enough smart regulators in place that can outwit private sector participants who really want to get around regulations. An essential part of improving regulation is to improve transparency, so the market can exert its discipline effectively.

²See, “Pew Financial Reform Project Note #2: Choosing Agency Mandates”, by Charles Taylor.

The Independence of the Federal Reserve

In applying this approach, it is vital for both the economy and the financial sector is that the Federal Reserve has independence as it makes monetary policy. Experience in the U.S. and around the world supports the view that an independent central bank results in better macroeconomic performance and restrains inflationary expectations. An independent Fed setting monetary policy is essential.

The Main Regulators and Lessons From the Crisis

The main Federal microprudential regulators had mixed performance at best during the recent crisis.

OTS did worst, losing its most important institutions—WaMu, IndyMac, and AIG—to sale and outright failure. Without any economies of scale in regulation, OTS suffered from a small staff in relation to their supervisory responsibilities. Its revenue was dominated by fees on a very small number of institutions, leading to regulatory capture. And, as many have observed, OTS lax standards attracted institutions to a thrift charter and it became the weakest link in the Federal financial depository regulatory chain. The lessons were: regulatory competition can create a *de facto* race to the bottom; and large institutions cannot be supervised and regulated effectively by small regulators—not only because of the complexity of the task but also because of capture.

The Office of the Comptroller of the Currency (OCC) fared only somewhat better. Their responsibilities were far wider and their resources were far greater. Nevertheless, several of their larger institutions failed and had to be rescued or absorbed. While an element of the problem was that there were parts of these institutions where their writ did not reach—OCC-regulated banks bought billions of dollars of CDOs, putting many of them into off-balance-sheet entities—it was not the only problem. Somehow, even this relative powerhouse failed to see the crisis coming. The lessons were: even the best of the Federal regulators may not have been up to the demanding task of overseeing highly complex financial institutions; and balkanized and incomplete coverage by microprudential regulators can be fatal.

The FDIC is rightly given credit for having championed the leverage ratio as an important tool of policy. While the Fed and the OCC became increasingly enamored of Basel II over the past 10 years, the FDIC suffered repeated criticism for their stick-in-the-mud insistence on the leverage ratio. On that issue, they have been vindicated not only here in the U.S., but internationally. But they did not do so well in prompt corrective actions during this crisis. Their insurance fund dropped from \$45bn to \$10bn in 12 months. Several of the firms that failed were well capitalized just days beforehand. The lesson is that liquidity and maturity transformation can matter as much as leverage in a crisis. Prompt corrective action focused on capital ratios alone is not enough.

While some State regulators have a fine record, nonbank financial institutions, largely overseen at the State level, were a major source of trouble in the recent financial crisis. Often working with brokers, these institutions originated many of the subprime, prime, and jumbo mortgages that have subsequently defaulted. They provided the initial funding for mortgages, but then quickly sold them to other entities to be packaged and securitized into the CDOs that were sliced and diced and resold with high credit ratings of dubious quality. They made money by pushing mortgages through the system and did not carry risk when these mortgages defaulted. Many State regulators failed to control bad lending practices. The main lessons: skin in the game is needed to keep the “handlers” of securitizations honest; and any reform of financial regulation has to somehow strengthen State regulation as well as Federal.

Perhaps the most difficult regulator to assess in the current crisis is the Federal Reserve.

More than any other institution, it has prevented the financial system from falling off a cliff through often brilliant and unprecedented interventions during the worst days of the crisis. I have expressed publicly my admiration for the job that Ben Bernanke has done in managing this crisis with Secretary Geithner and others. Taxpayers are understandably angry because of the funds that have been spent or put at risk in order to preserve the financial sector, but the alternative of a more serious collapse would have been much worse. The historical experience of financial crises here in the United States and around the world is that a banking collapse causes terrible hardship to the economy, even worse than the current recession. Bernanke and Geithner have helped avoid that disaster scenario.

However, the Fed did nothing at all for 14 years to prevent the deterioration in mortgage lending practices, even though Congress had given it the authority to do so in 1994 under HOEPA. Several of the bank holding companies under Fed supervision faced severe problems in the crisis—its microprudential regulation was inef-

fective. And, while the Fed has repeatedly claimed that systemic risk management was their responsibility, they failed to anticipate, or even prepare for, the crisis in any meaningful way.

In short, in its role as a regulator of bank holding companies, the record of the Fed is not good. Bank regulation has been something of a poor relation at the Fed compared to the making of monetary policy. The Fed as an institution has more stature and standing than any other Federal financial institution, but this stature comes from its control over monetary policy, not on its role in bank supervision and regulation. In addition, the Fed's powers were limited. It could not gain access to key information from many large financial institutions and had no power to regulate them. Lehman and Bear Stearns are two examples.

While, the Fed has increased its knowledge and understanding of the large banks as a result of managing the crisis and conducting the stress tests, the lessons are: having an institution with a secondary mandate for consumer protection (under HOEPA) does not work well; and the Fed's focus on monetary policy also makes it difficult to direct enough institutional focus on supervision.

Finally, there is the Securities and Exchange Commission which did an abysmal job in this crisis. It told the public that Bear Stearns was in fine shape shortly before the company failed; in fact it failed to supervise effectively any of the bulge bracket firms, Merrill Lynch, Bear Stearns, Goldman Sachs, Morgan Stanley, and Lehman). It did nothing to restrain the credit agencies from hyping the ratings of CDOs. And it did not stop Madoff and others from defrauding investors. However, the leadership has changed at the SEC and I believe it has learned important lessons from the crisis: its strong suit is not microprudential regulation of institutions; it must focus on investor protection and the integrity of the markets—not only the traditional ones like the stock and bond markets, but also the securitization market—including the development and implementation of policies to revamp securitization credit ratings.

One vital issue to recognize in regulating the large financial institutions is that they are run as single businesses. They decide what their business strategies will be and how to execute them most effectively. The specific legal forms they choose for their different divisions is determined by what they think will work best to achieve their strategic goals, given the tax, regulatory and legal environment that policymakers have set up. Under the current regulatory system, the Fed supervises and regulates the bank holding company while, for example, the OCC supervises the U.S. banks that are the subsidiaries of the holding company. Most of the large financial institutions are in several lines of business and, at present, are regulated by more than one agency. Inevitably, this encourages them to shift activities to the subsidiary and hence the regulator that is most tolerant of the activity they want to pursue. Balkanized regulation is unlikely to stop the next crisis.

This short review is not inclusive. There are credit unions that have a separate regulator and there are important issues around the GSE's and their regulation and around derivatives and their regulation that I will not tackle in this testimony. This review has been critical of the regulatory agencies but I want to note that there are many people to blame for the financial crisis, including bankers who took excessive risks and failed to do due diligence on the assets they purchased. Economists generally did not predict that such a severe crisis was possible. Very few people saw the possibility of a 20 percent or more decline in the price of housing and almost nobody saw the depth of problems that have resulted from the sharp declines in house prices.

What Structure Best Meets the Objectives of Financial Regulation?

Regulatory Performance Must Be Improved Regardless of Where It Is Done

There must be improved performance in the supervision and regulation of financial institutions regardless of who is doing it. There were rooms full of regulators sitting in all of the large regulated financial institutions prior to the crisis and they failed to stop the crisis. This means there should be more accountability for regulators, so that they are censured or removed if they do not perform the role they were hired to do. It means they should be better paid. It seems paradoxical to reward a group that did not do so well historically, but if we want better regulators then they must receive salaries that make their jobs attractive to high quality people, those who can understand complex institutions and products and who may have the option of earning high incomes in the private sector. Adequate training must be available. Better quality regulation is a “must-have” of financial reform and must be part of the legislation now being considered. A lot of improvement can be made even under existing legislation if regulators have the incentives and abilities to do their jobs.

Some people argue that regulation has been the cause of the problem and that if the Government were removed from the equation then the financial sector would regulate itself, with weak companies failing and the strong companies surviving. Overall, I am a strong supporter of letting markets work and letting companies fail if they cannot be efficient or innovative. This includes financial institutions that should be allowed to fail if they do make bad decisions and fail to meet the market test. The financial sector has unique features that make it different from most other industries, however. Failure in one institution can spill over to others and problems in the financial sector can rock the whole economy, as we have seen in this crisis. Regardless of one's perspective on this issue, however, it is clearly a mistake to create worst of both worlds. If the Government provides a safety net for consumer deposits and props up financial institutions in a crisis, then there must be effective high quality regulation that will protect the interests of taxpayers.

The Case for a Consolidated Microprudential Regulator for the Financial Sector

A single prudential regulator would become a powerful institution with stature in the policy community that could hire talented staff and attract strong and able leadership. It would be formed by drawing together the best people from the existing supervisors and regulators in the OCC, the OTS, the SEC, the FDIC, and the Federal Reserve, it would hire financial experts in areas where more expertise was needed, and it would be the primary supervisor of the institutions that make up the financial sector of the United States. The head of the organization would be chosen by the President with the consent of the Senate and would serve for a term of several years. It would be worth considering a structure like that of the Federal Reserve, with a board that served staggered 16 year terms. Thus constituted, the financial regulator would have the standing and capability to stand up to the heads of leading financial institutions and to be an independent arbiter. It would be a partner with and advisor to the Administration, Congress and the Federal Reserve.

The financial sector does not stand still. It evolves and innovates and new institutions and products are born. A single prudential regulator with the necessary staff and skills would be best positioned to evolve along with the industry and adapt regulation to a changing world. Having a single prudential regulator would make it much easier to avoid gaps in regulation and discourage the kind of regulatory evasion that contributed to the crisis. It would also reduce the regulatory burden on financial institutions because it would avoid much of the duplication that now exists.

A single prudential regulator would supervise and regulate large institutions and small and be able to maintain a level playing field for competition. It would be able to examine all of the activities of the large global banks and make sure they were not accumulating excessive risks through a combination of activities in different parts of their business.

There is a great deal to be said for competition in our economy. Ultimately, competition in the private sector drives innovation and growth and provides choices to consumers. It is the lifeblood of our economy. It is not clear, however, that competition among regulators a good thing. The serious danger in regulatory competition is that it allows a race to the bottom as financial institutions seek out the most lenient regulator that will let them do the risky things they want to try, betting with other people's money. One possible advantage of regulatory competition is that it could make it easier for companies to innovate whereas a single regulator might become excessively conservative and discourage new products even if these would bring substantial benefits. However, given the experience of the recent crisis, the dangers created by multiple regulators, including a race to the bottom, are greater and outweigh the possible advantages of competition among regulators.

An effective single prudential regulator acting as a cop on the beat could actually increase the level of effective competition among private companies in the financial sector, thus making the private market work better. In addition, it would be very important that the mandate of the single prudential regulator include the promotion of innovation and economic growth. The U.S. financial sector has been one of the strongest in the world and has been one of our major exporters. Prior to the crisis there was great concern that the New York financial markets were losing their global competitive position—See, for example the Bloomberg-Schumer report. The goal of sustaining a dynamic and competitive sector remains vital.

Another advantage of creating a single Federal prudential regulator is that it would enhance the independence of the Federal Reserve in making monetary policy. It gets the Fed out of the regulatory business and lets it concentrate on its main tasks.

The Role of the FDIC

With a single microprudential regulator, the FDIC would lose the supervisory and regulatory authority it has now. Staff from the FDIC that have performed well in this crisis would move to the new prudential regulator, so there would not be a loss of knowledge or expertise. The role of the FDIC as manager and supervisor of the deposit insurance fund would continue. In this position, it would also be able to sound warnings about depository institutions in difficulties, acting as a backup for the new unified prudential regulator. Another possibility is that the FDIC would become the principle agency dealing with the resolution of failing institutions.³

The SEC as the Conduct of Business Regulator

Under the single prudential regulator described above, the SEC would lose its authority to supervise nonbank financial institutions, which would reside instead with the prudential regulator. The SEC would continue to have a very important role as a protector of the interests of shareholders, a bulwark against insider trading, market manipulation, mis-selling and other practices that can undermine our capital markets. There is a case for giving the SEC additional authority to provide consumers protection against financial products that are deceptive or fraudulent.

The Treasury White Paper proposed establishing a new standalone agency, the CFPB, to provide consumer protection and it is understandable that such a proposal is made given what has happened. There were a lot of bad lending practices that contributed to the financial crisis. As noted earlier, many brokers and banks originated mortgages that had little chance of being repaid and that pushed families onto the street, having lost their savings. There was also misbehavior by borrowers, some of whom did not accurately report their income or debts or manipulated their credit scores. I agree with the Administration and many in Congress—notably Chairman Dodd—on the importance of protecting families against a repetition of the bad behavior that proliferated in recent years.

My first choice would be to place the responsibility for consumer protection in a new division within the SEC rather than creating a separate agency. The proliferation of regulators was a contributory factor in the crisis, so that adding a new agency is something that should be done reluctantly. While the SEC did badly in the crisis, there has been an important change in leadership and the new head of the agency is clearly someone of strength and talent who has pledged reform in the operations of the agency. Congress should ask the SEC to form a new CFPB division within its ranks charged specifically with consumer protection.⁴

Placing the tasks of the CFPB into the SEC would create a single strong conduct of business regulator with divisions specifically tasked to protect both consumers and small and minority shareholders. It would also make it easier to gain acceptance for greater consumer protection from the financial industry. The CFPB has become a lightning rod for opposition to regulatory reform. Given that the financial sector is largely responsible for the crisis, it is surprising that this sector is now lobbying so hard against greater consumer protection. Greater protection for consumers is needed and that would also provide greater protection for taxpayers. However, having the CFPB functions as a division within the SEC would accomplish that goal while calming industry fears.

Having the CFPB functions within the SEC is my first choice, but if Congress decides against this approach, I could support a standalone agency. The Treasury White Paper does a good deal to allay the fears that the new agency would stifle innovation, including: the overall focus on unfair, deceptive, and dangerous practices, rather than risk, *per se*; the instruction to weigh economic costs and benefits; the instruction to place a significant value on access to financial products by traditionally underserved consumers; the prohibition against establishing usury limits and; the option to consider previous practice in regard to financial products. The

³I have testified to this Committee before on the dangers of “too big to fail” or “too interconnected to fail.” An important aspect of regulatory reform is to make sure badly run financial companies are allowed to fail in a way that does not imperil the whole system, either through a resolution mechanism or through a special bankruptcy court. The FDIC would play an important role with either system.

⁴The Federal Reserve did not do a good job in protecting consumers in the period leading up to this crisis, nor did it stop the erosion of mortgage lending standards that contributed to build up of toxic assets in the financial system. Since the crisis, however, the consumer protection division within the FED has been strengthened and is now an effective force with strong leadership. The personnel from the consumer protection division of the FED, together with the best personnel in this function in other agencies, could be moved into the new CFPB division.

Treasury recognizes the dangers of having an agency that would overreach and its proposed structure would avoid that possibility.⁵

One final issue with the CFPA is preemption. The Treasury proposal indicates that State regulators would have the power to enact consumer protection legislation that was stronger than that in the Federal statute. I understand the case for States' rights in this arena, but the prospect of a myriad of different State rules is daunting and has the potential to reduce the efficiency of the massive U.S. marketplace. There has been enormous progress towards a single market in financial products, leveling the playing field for businesses and consumers, so that the terms of loans or other financial activities are the same in all States. Whether or not Federal consumer protection rules preempt State rules is not a major issue for safety and soundness, but having single set of consumer rule uniform in all States would improve economic efficiency. As a result, I support the view that Federal rules should preempt State rules in this area.

Regulating State Chartered Financial Institutions

Starting with a clean sheet of paper, I would prefer to see all banks and relevant nonbank financial institutions have Federal charters and be supervised by the unified prudential regulator. However, that is not the situation we are in and I recognize the importance of States' rights and the desire to have local institutions that can help local businesses by using the power of personal knowledge and relationships. It is a fact of life that there will continue to be State chartered banks subject to State supervision.

In the short run, it is unlikely that we will see again State chartered nondepository institutions that are originating and selling bad mortgages. The markets have been burned and will remember for a while that such institutions may not be selling quality products. Over the years, however, memories will fade and regulatory reform enacted today should avoid problems in the future as far as possible. I urge Congress to require State regulators to partner with the Federal prudential regulator in order to harmonize safety and soundness standards and to exchange information for State chartered banks and nonbanks. The Federal prudential regulator should set out minimum standards that it would like to see in State run financial institutions. And State regulators should be required to exchange data with the Federal regulator and work in cooperation with them. This is already how things work for most banks and it is important that we do not see in the future a situation where State charters are exploited by nonbank financial institutions to undercut the safety of the financial system.

The Federal Reserve as Systemic Risk Monitor or Regulator

The Treasury White Paper has proposed that there be a council, an extension of the President's Working Group on financial stability to coordinate information and assess systemic risk. The Working Group has played a valuable role in the past and I support its extension to include the leaders of all institutions with power to regulate the financial sector. As others have said, however, committee meetings do not solve crises.

The proposal outlined earlier in this testimony is for a single microprudential regulator, which would deprive the Fed of all its microprudential functions. However, I propose that monitoring and managing systemic stability and responding to increased exposure to systemic risks formally be added to the Fed's responsibilities. The strong performance of the Fed in managing this crisis strongly suggests that this institution should be the primary systemic risk monitor/regulator. Moreover, this role is a natural extension of monetary policy, which can be thought of as the monitoring of, and response to, macroeconomic developments. It fits with the dominant culture of economists and the Fed's strong tradition of independence, which are both needed for systemic risk management to be effective. It would slightly cut into the role you have proposed for the Financial Services Oversight Council, but not much.

For monitoring the economy and for making monetary policy the Fed needs, among other things, quick access to a broad base of financial information. Currently, the regulatory reporting is primitive. More complete, relevant and real time data should be available to all Federal financial regulators. A coordinated information strategy for the Federal financial regulatory agencies ought to be one of the first tasks of the FSOC. The Fed as systemic regulator would need to work closely with the prudential regulator so that it knows what is going on inside the big institu-

⁵ See, additional discussion of these issues by Douglas Elliott of Brookings and also by the current author posted on the Brookings Web site. The financial reform project of the Pew Charitable trusts has also posted material on the topic.

tions, and the small ones. It would also need to work closely with the Treasury and the FSO, exchanging information with all members that could help it see dangerous trends as they emerge.

To respond to specific systemic risks, the Fed needs another instrument in addition to its control over short term interest rates and I suggest that Congress should grant the Fed the power to adjust minimum capital, leverage, collateral and margin requirements generally in response to changing systemic risks, in addition to the specific power it has had to adjust margin requirements in stock trading since the Great Depression. The microprudential regulator would set basic minimum standards. The Fed would adjust a “multiplier” up or down as systemic circumstances required. This additional power should be used rarely and in small increments; recall how the Volcker-Carter credit restrictions stopped the U.S. economy on a dime in 1980.

No one can guarantee that a systemic regulator will be able to foresee the next bubble or crisis, but it is definitely worth the effort to spot trouble forming. In particular, the Fed may be able to spot a concentration of purchases of risky assets made with borrowed funds. A systemic regulator could have seen that many banks had lent large sums to LTCM to speculate in Russian bonds or other risky assets. It should have been able to spot the build up of risky CDOs in SIVs that were affiliated with the banks. It could potentially see if large hedge funds or private equity companies were using borrowed funds and concentrating on a particularly risk class of assets. Analysts who were studying the real estate market prior saw signs of trouble well before the crisis started.

Conclusions

A single strong agency would meet the objective of microprudential regulation of all financial institutions that were subject to regulation and supervision. It would work with State regulators, especially to make sure the abuses that contributed to the crisis could not be repeated. It would work closely with the conduct of business regulator(s) (the SEC and the CFPB) and the Federal Reserve to ensure that consumer protection is adequate, that monetary policymakers are well informed and that all these institutions and the Treasury would work together effectively to deal with a new crisis should it occur in the future.

The Federal Reserve has shown its mettle in managing the crisis and should be given the role of principle systemic regulator or monitor. It would work closely with the members of the risk council in performing this task. It should have the power to adjust borrowing rules prudently if it sees a bubble developing driven by excessive leverage.

The SEC is the natural institution to become the conduct of business regulator with a mandate to protect small and minority shareholders and, with a CFPB division, also to protect consumers in financial markets. A single prudential regulator plus a single conduct of business regulator would constitute the so-called “twin peaks” approach to regulation that many experts around the world see as the best regulatory structure. However, a well-designed standalone CFPB could also be an effective protector of consumers and taxpayers.

Appendix: Lessons From the U.K. and Australia

Opponents of regulatory consolidation in the United States frequently cite the experience of the United Kingdom, which has a consolidated regulator, the Financial Services Authority (FSA) but did not escape the crisis, indeed it has suffered perhaps even worse than the United States. Given London’s status as a global financial center it was to be expected that the U.K. would face problems in the global crisis, but it is surprising that the extensive regulatory reforms undertaken in the late 1990s did not better insulate the country from the effects of the financial crisis.

In 1997 the U.K. overhauled its financial regulatory system, combining a myriad of independent regulatory authorities (including the regulatory functions of the Bank of England, the Securities Investment Board, and the Securities Futures Board, among nine total) into a single entity. Then Chancellor of the Exchequer Gordon Brown argued that the distinctions between banks, securities firms and insurance companies had broken down, and that in this new era of more fluid and interchangeable institutional definitions, the old regulatory divisions no longer made sense. The FSA’s statutory objectives are to maintain market confidence, to promote public awareness on financial matters, to protect consumers, and to reduce financial crime. To achieve those ends, the FSA employs broad investigatory, enforcement, and prosecutorial powers.

Although the external structure of regulation in the U.K. may appear simple enough, there is a great deal of internal complexity. There are two main branches within the FSA; one branch which deals with retail markets and another branch,

which focuses on wholesale and institutional markets. Within each branch, there are further divisions based on specific financial activities and institutional design, including insurance, banking and mortgages, asset management, and credit unions. There also exist some internal groups which look at specific financial activities in each of the retail and wholesale sectors. Therefore, in practice the FSA did not create an effective single prudential regulator. Instead it preserved some of its older agency divisions, albeit under a single umbrella. Critics of the FSA have pointed to the haste with which the FSA was formed and the failure of the new integrated regulator to fully overcome the old institutional divisions of its former approach to regulation.

The FSA has admitted on its own to significant failings over Northern Rock. An internal FSA report cited inadequate resources devoted to overseeing the institution, including high personnel turnover and limited direct contact with the institution (no one had visited the bank for 3 years), and a failure to push management at the bank to modify an eventually disastrous business model.⁶ The U.K. Government was determined to develop London as the key financial center in Europe and that London could compete effectively with New York. As part of this strategy, they instituted “light touch” regulation, in which financial institutions were given the goals or principles that they should follow but were given considerable leeway to determine how the goals should be met. While there is some merit in this approach, it created significant danger and it meant in practice that U.K. financial institutions took on excessive risks. Some U.K. banks developed a reputation around the world for lending money to companies that local banks would not touch and the regulators were not stopping them from taking these bad risks.

Another problem is that there was totally inadequate communication between the FSA and the Bank of England. The Bank of England was intent on maintaining its independence and focused on its mission of fighting inflation. When the crisis struck, the Bank was unwilling to step in quickly to support troubled institutions and markets because it had not been kept up to date about the condition of the banks and had not been tasked with the job of maintaining system stability.

In summary, the U.K. experience does not provide an appropriate counter example for the regulatory model proposed in this testimony. They did not create an effective, strong single prudential regulator. They did not make the Bank of England responsible for systemic stability, nor did they ensure that the Bank of England was informed about the condition of the U.K. banks.

Australia does not have a major financial center serving the global market and so it cannot provide an ideal example for the United States to copy. Nevertheless, the Australian regulatory reforms seem to have been well designed and well-executed and there are some lessons to be learned.

Australia determined that the “twin peaks” model was the right one and they created the Australian Prudential Regulatory Authority (APRA), which is responsible for prudential regulation while the Australian Securities and Investment Commission (ASIC) oversees conduct-of-business regulation. A cross-agency commission seeks to resolve conflicts of overlap and facilitate communication between the two agencies.

The Australian economy weathered the financial crisis better than many other developed countries, and its experience owes much of its better-than-average performance during the financial crisis to sound policy choices and the effectiveness of its financial regulation. There was not a housing bubble and there was not the same erosion in lending standards as had occurred in the U.S. This was in part due to stricter regulation of mortgage lending. Australia’s prudential regulator had raised capital requirements for banks investing in riskier mortgage products.⁷ Consumer protection laws and foreclosure laws also discouraged borrowers from taking out mortgages that they could not afford.

Until 1998 Australian financial regulation resided with the country’s Central Bank and took an institutional approach. Following a review of the country’s overall financial system, the twin peaks approach was put into place. As in the U.K., APRA’s regulation is a largely a principles-based approach, relying heavily on dialogue between the regulators and the regulated institutions, but with a considerably heavier touch by the regulators to guard against excessive risk taking.

The ASIC oversees securities market and financial services providers. ASIC has the power to impose criminal or civil sanctions against financial firms or individuals. As a corporate regulator, ASIC oversees company directors and officers, capital raising, takeovers, financial reporting, *etc.* It also provides licensing and monitoring

⁶ Hughes, 2008.

⁷ Ellis, 2009.

for financial services firms. In addition, ASIC has been tasked to protect consumers against misleading or deceptive conduct related to financial products and services.

The Australian approach is cited as a model for other countries, for example in the Paulson Treasury's blueprint, in part because it allows flexibility and innovation, while maintaining protections. The regulatory structure is not the only reason for the fact that their economy avoided the worst of the financial crisis, but it seems to have helped. One aspect of the Australian regulatory approach that could serve as a model is the process by which it arrived at reform. Where the road to reform in the U.K. was hasty and lacked adequate consideration, the Australian reform process began with the Wallis Inquiry in 1996 to review how financial system reform could be structured in Australia. The inquiry looked specifically at how prior attempts at deregulation had affected the Australian financial system, what forces were at work changing the system further, and what would provide the most efficient, effective and competitive regulatory structure for the country going forward.

In summary, Australia provides a good positive example where a single prudential regulator has worked well.

PREPARED STATEMENT OF RICHARD S. CARNELL

ASSOCIATE PROFESSOR, FORDHAM UNIVERSITY SCHOOL OF LAW

SEPTEMBER 29, 2009

Mr. Chairman, Senator Shelby, Members of the Committee: You hold these hearings in response to an extraordinary financial debacle, costly and far-reaching: a debacle that has caused worldwide pain and will saddle our children with an oversized public debt. "And yet," to echo President Franklin D. Roosevelt's inaugural address, "our distress comes from no failure of substance. We are stricken by no plague of locusts. . . . Plenty is at our doorstep." Our financial system got into extraordinary trouble—trouble not seen since the Great Depression—during a time of record profits and great prosperity.

This disaster had many causes, including irrational exuberance, poorly understood financial innovation, loose fiscal and monetary policy, market flaws, regulatory gaps, and the complacency that comes with a long economic boom. But our focus here is on banking, where the debacle was above all a regulatory failure. Banking is one of our most heavily regulated industries. Bank regulators had ample powers to constrain and correct unsound banking practices. Had regulators adequately used those powers, they could have made banking a bulwark for our financial system instead of a source of weakness. In banking, as in the system as a whole, we have witnessed the greatest regulatory failure in history. Our fragmented bank regulatory structure contributed to the debacle by impairing regulators' ability and incentive to take timely preventive action. Reform of that structure is long overdue.

In my testimony today, I will:

1. Note how regulatory fragmentation has grave defects, arose by happenstance, and persists not on its merits but through special-interest politics and bureaucratic obduracy;
2. Recommend that Congress unify banking supervision in a new independent agency; and
3. Reinforce the case for reform by explaining how regulatory fragmentation helps give regulators an unhealthy set of incentives—incentives that hinder efforts to protect bank soundness, the Federal deposit insurance fund, and the taxpayers.

I. Fragmentation Impedes Effective Supervision

Fragmentation Is Dysfunctional

Our fragmented bank regulatory structure is needlessly complex, needlessly expensive, and imposes needless compliance costs on banks. It "requires too many banking organizations to deal with too many regulators, each of which has overlapping, and too often maddeningly different, regulations and interpretations," according to Federal Reserve Governor John LaWare. It engenders infighting and impedes prudent regulatory action. FDIC Chairman William Seidman deplored the stubbornness too often evident in interagency negotiations: "There is no power on earth that can make them agree—not the President, not the Pope, not anybody. The only power that can make them agree is the Congress of the United States by changing the structure so that the present setup does not continue." The current structure promotes unsound laxity by setting up interagency competition for bank clientele. It also blunts regulators' accountability with a tangled web of overlapping jurisdic-

tions and responsibilities. Comptroller Eugene Ludwig remarked that “it is never entirely clear which agency is responsible for problems created by a faulty, or overly burdensome, or late regulation. That means that the Congress, the public, and depository institutions themselves can never be certain which agency to contact to address problems created by a particular regulation.”

Senator William Proxmire, longtime Chairman of this Committee, called this structure “the most bizarre and tangled financial regulatory system in the world.” Treasury Secretary Lloyd Bentsen branded it “a spider’s web of overlapping jurisdictions that represents a drag on our economy, a headache for our financial services industry, and a source of friction within our Government.” Chairman Seidman derided it as “complex, inefficient, outmoded, and archaic.” The Federal Reserve Board declared it “a crazy quilt of conflicting powers and jurisdictions, of overlapping authorities, and gaps in authority” (and that was in 1938, when the system was simpler than now). Federal Reserve Vice Chairman J.L. Robertson went further:

The nub of the problem . . . is the simple fact that we are looking for, talking about, and relying upon a system where no system exists. . . . Our present arrangement is a happenstance and not a system. In origin, function, and effect, it is an amalgam of coincidence and inadvertence.

Opponents of reform portray a unified supervisory agency as ominous and unnatural. Yet although the Federal Government regulates a wide array of financial institutions, no other type of institution has competing Federal regulators. Not mutual funds, exchange-traded funds, or other regulated investment companies. Not securities broker-dealers. Not investment advisers. Not futures dealers. Not Government-sponsored enterprises. Not credit unions. Not pension funds. Not any other financial institution. A single Federal regulator is the norm; competition among Federal regulators is an aberration of banking.

Federal Financial Institution Regulators	
<i>Institution Type</i>	<i>Agency</i>
Futures dealers	Commodity Futures Trading Commission
GSEs—Agricultural	Farm Credit Administration
GSEs—Housing	Federal Housing Finance Agency
Pension funds	Internal Revenue Service; Dept. of Labor
Credit unions	National Credit Union Administration
Investment advisers	Securities & Exchange Commission
Investment companies	Securities & Exchange Commission
Securities broker-dealers	Securities & Exchange Commission

Nor do we see competition among Federal regulators when we look beyond financial services—and for good reason. Senator Proxmire observed:

Imagine for a moment that we had seven separate and distinct Federal agencies for regulating airline safety. Imagine further the public outcry that would arise following a series of spectacular air crashes while the seven regulators bickered among themselves on who was to blame and what was the best way to prevent future crashes.

There is no doubt in my mind that the public would demand and get a single regulator. There is a growing consensus among experts that our divided regulatory system is a major part of the problem. There are many reasons for consolidating financial regulations, but most of them boil down to getting better performance.

Fragmentation Is the Product of Happenstance

Two forces long shaped American banking policy: distrust of banks, particularly large banks; and crises that necessitated a stronger banking system. Our fragmented regulatory structure reflects the interplay between these forces. As FDIC Chairman Irvine H. Sprague noted, this structure “had to be created piecemeal, and each piece had to be wrested from an economic crisis serious enough to muster the support for enactment.”

Distrust of banking ran deep from the beginning of the Republic. John Adams, sober and pro-business, declared that “banks have done more injury to the religion, morality, tranquility, prosperity, and even wealth of the Nation than they have done or ever will do good.” Thomas Jefferson asserted that states “may exclude [bankers] from our territory, as we do persons afflicted with disease.” Andrew Jackson won reelection pledging to destroy the Nation’s central bank, which he likened to a malicious monster. This powerful, longstanding distrust of banking shaped U.S. law in ways that, until recent decades, kept U.S. banks smaller and weaker (relative to the size of our economy) than their counterparts in other developed countries.

Yet banking proved too useful to ignore or suppress. To cope with financial emergencies, Congress acted to strengthen the banking system. It created:

- National banks to finance the Civil War and the OCC to supervise national banks;
- The Federal Reserve in response to the Panic of 1907;
- The FDIC, its thrift-institution counterpart, and the Federal thrift charter to help stabilize the financial system during the Great Depression; and
- The Office of Thrift Supervision in response to the thrift debacle of the 1980s.

These and other *ad hoc* actions gave us a hodgepodge of bank regulatory agencies unparalleled in the world. Each agency, charter type, and regulatory subcategory developed a political constituency resistant to reform.

The Bank Holding Company Act, another product of happenstance, exacerbated this complexity. It ultimately gave most banking organizations of any size a second Federal regulator: the Federal Reserve Board. As enacted in 1956, the Act sought to prevent “undue concentration of economic power” by limiting banks’ use of holding companies to enter additional businesses and expand across State lines. The Act reflected a confluence of three disparate forces: populist suspicion of bigness in banking; special-interest politics; and the Federal Reserve Board’s desire to bolster its jurisdiction. Representative Wright Patman, populist chairman of the House Banking Committee, sought to prevent increased concentration in banking and the broader economy. Small banks sought to keep large banks from expanding into new products and territory. A variety of other firms sought to keep banks out of their businesses. The Fed gained both expanded jurisdiction and a respite from Chairman Patman’s attempts to curtail its independence in monetary policy.¹ The Act originally applied only to companies owning two or more banks. But in 1970 Congress extended the Act to companies owning a single bank.

Special-Interest Politics Perpetuate Fragmentation

Regulatory fragmentation leaves individual agencies smaller, weaker, and more vulnerable to pressure than a unified agency would be. It can also undercut their objectivity. Fragmentation played a pivotal role in the thrift debacle. Specialized thrift regulators balked at taking strong, timely action against insolvent thrifts. Regulators identified with the industry and feared that stern action would sharply shrink the industry and jeopardize their agencies’ reason for being. In seeking to help thrifts survive, the regulators multiplied the ultimate losses to the deposit insurance fund and the taxpayers. For example, they granted sick thrifts new lending and investment powers for which the thrifts lacked the requisite competence (*e.g.*, real estate development and commercial real estate lending).

By contrast, bank regulators who also regulated thrifts took firmer, more appropriate action (*e.g.*, limiting troubled institutions’ growth and closing deeply insolvent institutions). These policies bore fruit in lower deposit insurance losses. State-chartered thrifts regulated by State banking commissioners were less likely to fail—and caused smaller insurance losses—than thrifts with a specialized, thrift-only regulator. Likewise, thrifts regulated by the FDIC fared far better than those regulated by the thrift-only Federal Home Loan Bank Board.

II. Unifying Federal Bank Supervision

Fragmentation problems have a straightforward, common-sense solution: unifying Federal bank regulation. Treasury Secretary Lloyd Bentsen offered that solution here in this room 15 years ago. As Assistant Secretary of the Treasury for Financial Institutions, I worked with him in preparing that proposal. He made a cogent case then, and I’ll draw on it in my testimony now.

Secretary Bentsen proposed that we unify the supervision of banks, thrifts, and their parent companies in a new independent agency, the Federal Banking Commis-

¹ Mark J. Roe, “Strong Managers, Weak Owners: The Political Roots of American Corporate Finance”, 99–100 (1994).

sion. The agency would have a five-member board, with one member representing the Treasury, one member representing the Federal Reserve, and three independent members appointed by the President and confirmed by the Senate. The President would designate and the Senate confirm one of the independent members to head the agency.

The commission would assume all the existing bank regulatory responsibilities of the Comptroller of the Currency, Federal Reserve Board, FDIC, and Office of Thrift Supervision. The Federal Reserve would retain all its other responsibilities, including monetary policy, the discount window, and the payment system. The FDIC would retain all its powers and responsibilities as deposit insurer, including its power to conduct special examinations, terminate insurance, and take back-up enforcement action. The three agencies' primary responsibilities would correspond to the agencies' core functions: bank supervision, central banking, and deposit insurance.

This structure would promote clarity, efficiency, accountability, and timely action. It would also help the new agency maintain its independence from special-interest pressure. The agency would be larger and more prominent than its regulatory predecessors and would supervise a broader range of banking organizations. It would thus be less beholden to a particular industry clientele—and more able to carry out appropriate preventive and corrective action. Moreover, a unified agency could do a better job of supervising integrated banking organizations—corporate families in which banks extensively interact with their bank and nonbank affiliates. The agency would look at the whole organization, not just some parts. Secretary Bentsen put the point this way:

Under today's bank regulatory system, any one regulator may see only a limited piece of a dynamic, integrated banking organization, when a larger perspective is crucial both for effective supervision of the particular organization and for an understanding of broader industry conditions and trends.

Having the same agency oversee banks and their affiliates both simplifies compliance and makes supervision more effective. We have no need for a separate holding company regulator.

Under the Bentsen proposal, the Fed and FDIC would have full access to supervisory information about depository institutions and their affiliates. Their examiners could participate regularly in examinations conducted by the commission and maintain their expertise in sizing up banks. As members of a Federal Banking Commission-led team, Fed and FDIC examiners could scrutinize the full spectrum of FDIC-insured depository institutions, including national banks. The two agencies would have all the information, access, and experience needed to carry out their responsibilities.

The Treasury consulted closely with the FDIC in developing its 1994 reform proposal. The FDIC supported regulatory consolidation in testimony before this Committee on March 2, 1994. It stressed that in the context of consolidation it had five basic needs. First, to remain independent. Second, to retain authority to set insurance premiums and determine its own budget. Third, to have "timely access" to information needed to "understand and stay abreast of the changing nature of the risks facing the banking industry . . . and to conduct corrective resolution and liquidation activities." Fourth, to retain power to grant and terminate insurance, assure prompt corrective action, and take back-up enforcement action. Fifth, to retain its authority to resolve failed and failing banks.

A regulatory unification proposal can readily meet all five of those needs. Indeed, Secretary Bentsen's proposal dealt with most of them in a manner satisfactory to the FDIC. The Treasury and FDIC did disagree about FDIC membership on the Federal Banking Commission. The FDIC regarded membership as an important assurance of obtaining timely information. The Treasury proposal did not provide for an FDIC seat, partly out of concern that it would entail expanding the commission to seven members. Now as then, I believe that the agency's board should include an FDIC representative.

The Federal Reserve and FDIC complain that they cannot properly do their jobs unless they remain the primary Federal regulator of some fraction of the banking industry. These complaints ignore the sort of safeguards in Secretary Bentsen's proposal. They also exaggerate the significance of the two agencies' current supervisory responsibilities. FDIC-supervised banks hold only 17 percent of all FDIC-insured institutions' aggregate assets; Fed-supervised banks, only 13 percent. Nor does the Fed's bank holding jurisdiction fundamentally alter the picture: the Fed as holding company regulator neither examines nor supervises other FDIC-insured institutions. The Fed and FDIC, in carrying out their core responsibilities, already rely primarily on supervisory information provided by others.

Thus it strains credulity to suggest that the FDIC cannot properly carry out its insurance and receivership functions unless it remains the primary Federal regulator of State nonmember banks. These banks, currently numbering 5,040, average \$460 million in total assets. How many community banks must the FDIC supervise to remain abreast of industry trends and remember how to resolve a community bank? Likewise, the Fed cannot plausibly maintain that its ability to conduct monetary policy, operate the discount window, and gauge systemic risk appreciably depends on remaining the primary Federal regulator of 860 State member banks (only 10 percent of FDIC-insured institutions), particularly when those banks average less than \$2 billion in total assets. Moreover, according to the most recent Federal Reserve Flow of Funds accounts, the entire commercial banking industry (including U.S.-chartered commercial banks, foreign banks' U.S. offices, and bank holding companies) holds only some 18 percent of our Nation's credit-market assets. In sum, the two agencies' objections to reform ring false. They are akin to saying, "I can't do my job right without being the supreme Federal regulator for some portion of the banking industry, small though that portion may be. Nothing else will do."

Nor do regulatory checks and balances depend on perpetuating our multiregulator jumble. "Regulatory power is not restrained by creating additional agencies to perform duplicate functions," Secretary Bentsen rightly declared. A unified banking supervisor would face more meaningful constraints from "congressional oversight, the courts, the press, and market pressures." Its decision making would also, under my recommendations, include the insights, expertise, and constant participation of the Federal Reserve Board and FDIC.

III. Regulatory Fragmentation Promotes Unsound Laxity

Most debate about banking regulation pays little heed to bank regulators' incentives. That's a serious mistake, all the more so given the recent debacle. As noted at the outset, regulators had ample powers to keep banks safe but failed to do so. This failure partly involved imperfect foresight (an ailment common to us all). But it also reflected an unhealthy set of incentives—incentives that tend to promote unsound laxity. These incentives discouraged regulators from taking adequate steps to protect bank soundness, the Federal deposit insurance fund, and the taxpayers. Economists refer to such incentives as "perverse" because they work against the very goals of banking regulation. These incentives represent the regulatory counterpart of moral hazard. Just as moral hazard encourages financial institutions to take excessive risks, these incentives discourage regulators from taking adequate precautions. To improve regulation, we need to give regulators a better set of incentives—incentives more compatible with protecting the FDIC and the taxpayers.

Several key factors create perverse incentives for bank regulators. First, we have difficulty telling good regulation from bad—until it's too late. Second, lax regulation is more popular than stringent regulation—until it's too late. Third, regulators' reputations suffer less from what goes wrong on their watch than from what comes to light on their watch. This is the upshot:

Bank Soundness Regulation Has No Political Constituency—Until It's Too Late.

To make the incentive problem more concrete, put yourself in the position of a regulator who, during a long economic boom and a possible real estate bubble, sees a need to raise capital standards. The increase will have short-term, readily identifiable consequences. To comply with the new standards, banks may need to constrain their lending and reduce their dividends. Prospective borrowers will complain. Banks' return on equity will decline because banks will need more equity per dollar of deposits. Hence bankers will complain. You'll feel immediate political pain. Yet the benefits of higher capital standards, although very real, will occur over the long run and be less obvious than the costs. Raising capital levels will help protect the taxpayers, but the taxpayers won't know it. Moreover, in pressing weaker banks to shape up and in limiting the flow of credit to real estate, you may get blamed for causing problems that already existed. From the standpoint of your own self-interest, you're better off not raising capital standards. You can leave office popular. By the time banks get into trouble, you'll have a new job and your successor will have to shoulder the problem.

Similar incentives encourage too-big-to-fail treatment. Bailouts confer immediate, readily identifiable benefits. By contrast, the costs of intervention (such as increased moral hazard and potential for future instability) are long-term, diffuse, and less obvious. But you can leave those problems for another day and another regulator. You risk criticism whether or not you intervene. But on balance you run a greater risk of destroying your reputation if you let market discipline take its course. Unwar-

ranted intervention may singe your career; a seemingly culpable failure to intervene will incinerate it.

Bank regulators need better incentives far more than they need new regulatory powers. Creating a unified regulator will make for a healthier set of incentives.

Conclusion

Now is the right time to fix the bank regulatory structure: now, while we're still keenly aware of the financial debacle; now, while special-interest pressure and bureaucratic turf struggles are less respectable than usual. Reform should promote efficiency, sharpen accountability, and help regulators withstand special-interest pressure.

Speaking from this table in 1994, Secretary Bentsen underscored the risk of relying on "a dilapidated regulatory system that is ill-designed to prevent future banking crises and ill-equipped to cope with crises when they occur." He observed, in words eerily applicable to the present, that our country had "just emerged from its worst financial crisis since the Great Depression," a crisis that our cumbersome bank regulatory system "did not adequately anticipate or help resolve." He also issued this warning, which we would yet do well to heed: "If we fail to fix [the system] now, the next financial crisis we face will again reveal its flaws. And who suffers then? Our banking industry, our economy, and, potentially, the taxpayers. You have the chance to help prevent that result."

PREPARED STATEMENT OF RICHARD J. HILLMAN
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GOVERNMENT ACCOUNTABILITY OFFICE

SEPTEMBER 29, 2009

United States Government Accountability Office

GAO

Testimony
Before the Committee on Banking,
Housing, and Urban Affairs, U.S. Senate

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FINANCIAL REGULATION

**Recent Crisis Reaffirms the
Need to Overhaul the U.S.
Regulatory System**

Statement of Richard J. Hillman, Managing Director
Financial Markets and Community Investment



Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss issues relating to efforts to reform the regulatory structure of the financial system. In the midst of the worst economic crisis affecting financial markets globally in more than 75 years, federal officials have taken unprecedented steps to stem the unraveling of the financial services sector. While these actions aimed to provide relief in the short term, the severity of the crisis has shown clearly that in the long term, the current U.S. financial regulatory system was in need of significant reform. Our January 2009 report presented a framework for evaluating proposals to modernize the U.S. financial regulatory system, and work we have conducted since that report further underscores the urgent need for changes in the system.¹ Given the importance of the U.S. financial sector to the domestic and international economies, in January 2009, we also added modernization of its outdated regulatory system as a new area to our list of high-risk areas of government operations because of the fragmented and outdated regulatory structure.² We noted that modernizing the U.S. financial regulatory system will be a critical step to ensuring that the challenges of the 21st century can be met. In my statement today, which is based on our reports and additional work we have completed, I will discuss (1) how regulation has evolved and recent work that further illustrates the significant limitations and gaps in the existing regulatory system, (2) the experiences of countries with other types of varying regulatory structures during the financial crisis, and (3) how certain aspects of proposals would reform the U.S. regulatory system.

To do this work, we synthesized existing GAO work and other studies on the financial crisis, such as those from the Department of Treasury, Group of Twenty (G20), Group of Thirty (G30), and the Committee on Capital Markets Regulation, among others. We also selected a judgmental sample of countries—Australia, Canada, The Netherlands, Sweden, and the United Kingdom—because they each had advanced financial markets and were illustrative of regulatory changes made internationally. We compiled information from publicly available sources on the individual countries' regulatory systems and the countries' experiences during the crisis. Finally, we used our framework of regulatory reform elements that was

¹GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO-09-216 (Washington, D.C.: Jan. 8, 2009).

²GAO, *High Risk Series: An Update*, GAO-09-271 (Washington, D.C.: Jan. 2009).

developed for our January 2009 report to analyze the strengths and weaknesses of legislative proposals on regulatory reform. Our work was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This work was conducted between August 2009 and September 2009.

Summary

The current U.S. financial regulatory system is fragmented due to complex arrangements of federal and state regulation put into place over the past 150 years. It has not kept pace with major developments in financial markets and products in recent decades. Today, almost a dozen federal regulatory agencies, numerous self-regulatory organizations, and hundreds of state financial regulatory agencies share responsibility for overseeing the financial services industry. Several key changes in financial markets and products in recent decades have highlighted significant limitations and gaps in the existing U.S. regulatory system. For example, regulators have struggled, and often failed, both to identify the systemic risks posed by large and interconnected financial conglomerates and to ensure these entities adequately manage their risks. In addition, regulators have had to address problems in financial markets resulting from the activities of sometimes less-regulated and large market participants—such as nonbank mortgage lenders, hedge funds, and credit rating agencies—some of which play significant roles in today's financial markets. Further, the increasing prevalence of new and more complex financial products has challenged regulators and investors, and consumers have faced difficulty understanding new and increasingly complex retail mortgage and credit products.

Our recent work has also highlighted significant gaps in the regulatory system and the need for an entity responsible for identifying existing and emerging systemic risks. For example, our July 2009 report on oversight of banks' fair lending practices revealed that the fragmented financial regulatory system limited the consistency and effectiveness of regulators' oversight of these practices. In addition, our recent reports on regulators' oversight of risk management systems found that regulators were not sufficiently focused on looking across institutions to identify factors that could affect the overall financial system was in part responsible for the failure to detect problems that significantly contributed to the crisis. Reports from a variety of international groups have identified similar

weaknesses in regulatory systems globally and have called for a number of reforms.

Various countries have implemented changes in their regulatory systems in recent years, but the current crisis affected most countries regardless of their structure. All of the countries we reviewed have more concentrated regulatory structures than that of the United States. Some countries, such as the United Kingdom, have chosen an integrated approach to regulation that unites safety and soundness and business conduct issues under a single regulator. Others, such as Australia, have chosen a “twin peaks” approach, in which separate agencies are responsible for safety and soundness and business conduct regulation. However, regardless of regulatory structure, each country we reviewed was affected to some extent by the recent financial crisis. One regulatory approach was not necessarily more effective than another in preventing or mitigating a financial crisis. However, regulators in some countries had already taken some actions that may have reduced the impact on their institutions. These and other countries also have taken or are currently contemplating additional changes to their regulatory systems to address weaknesses identified during this crisis.

The Department of the Treasury’s recent proposal to reform the U.S. financial regulatory system includes some elements that would likely improve oversight of the financial markets and make the financial system more sound, stable, and safer for consumers and investors. For example, under this proposal a new governmental body would have responsibility for assessing threats that could pose systemic risk. This proposal would also create an entity responsible for business conduct, that is, ensuring that consumers of financial services were adequately protected. However, our analysis indicated that additional opportunities exist beyond the Treasury’s proposal for additional regulatory consolidation that could further decrease fragmentation in the regulatory system, reduce the potential for differing regulatory treatment, and improve regulatory independence.

U.S. Financial Regulatory System's Failure to Keep Pace with Market Developments Underscores the Need for Reforms

As a result of 150 years of changes to financial regulation in the United States, the regulatory system has become complex and fragmented. Today, responsibilities for overseeing the financial services industry are shared among almost a dozen federal banking, securities, futures, and other regulatory agencies, numerous self-regulatory organizations, and hundreds of state financial regulatory agencies. For example:

- Insured depository institutions are overseen by five federal agencies—the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (Federal Reserve), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA)—and states supervise state-chartered depository and certain other institutions.
- Securities activities and markets are overseen by the Securities and Exchange Commission (SEC) and state government entities, and private sector organizations performing self-regulatory functions.
- Commodity futures markets and activities are overseen by the Commodity Futures Trading Commission (CFTC) and also by industry self-regulatory organizations.
- Insurance activities are primarily regulated at the state level with little federal involvement.

Other federal regulators also play important roles in the financial regulatory system, such as the Federal Trade Commission, which acts as the primary federal agency responsible for enforcing compliance with federal consumer protection laws for financial institutions such as finance companies that are not overseen by another financial regulator.

Much of this structure has developed as the result of statutory and regulatory measures taken in response to financial crises or significant developments in the financial services sector. For example, the Federal Reserve was created in 1913 in response to financial panics and instability around the turn of the century, and much of the remaining structure for bank and securities regulation was created as the result of the Great Depression turmoil of the 1920s and 1930s. Changes in the types of financial activities permitted for financial institutions and their affiliates have also shaped the financial regulatory system over time. For example, under the Glass-Steagall provisions of the Banking Act of 1933, financial institutions were prohibited from simultaneously offering commercial and investment banking services, but with the passage of the Gramm-Leach-



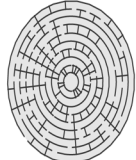
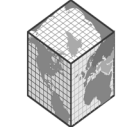
Bliley Act of 1999, Congress permitted financial institutions to fully engage in both types of activities, under certain conditions.

Various Market
Developments Have
Revealed Limitations in the
Existing Regulatory
Structure

Several key developments in financial markets and products in the past few decades have significantly challenged the existing financial regulatory structure.³ (See fig. 1.)

³GAO-09-216.

Figure 1: Key Developments and Resulting Challenges That Have Hindered the Effectiveness of the Financial Regulatory System

Developments in financial markets and products	Examples of how developments have challenged the regulatory system
 <p>Emergence of large, complex, globally active, interconnected financial conglomerates</p>	<p>Regulators sometimes lack sufficient authority, tools, or capabilities to oversee and mitigate risks.</p> <p>Identifying, preventing, mitigating, and resolving systemic crises has become more difficult.</p>
 <p>Less-regulated entities have come to play increasingly critical roles in financial system</p>	<p>Nonbank lenders and a new private-label securitization market played significant roles in the subprime mortgage crisis that led to broader market turmoil.</p> <p>Activities of hedge funds have posed systemic risks.</p> <p>Overreliance on credit ratings of mortgage-backed products contributed to the recent turmoil in financial markets.</p> <p>Financial institutions' use of off-balance sheet entities led to ineffective risk disclosure and exacerbated recent market instability.</p>
 <p>New and complex products that pose challenges to financial stability and investor and consumer understanding of risks.</p>	<p>Complex structured finance products have made it difficult for institutions and their regulators to manage associated risks.</p> <p>Growth in complex and less-regulated over-the-counter derivatives markets have created systemic risks and revealed market infrastructure weaknesses.</p> <p>Investors have faced difficulty understanding complex investment products, either because they failed to seek out necessary information or were misled by improper sales practices.</p> <p>Consumers have faced difficulty understanding mortgages and credit cards with new and increasingly complicated features, due in part to limitations in consumer disclosures and financial literacy efforts.</p> <p>Accounting and auditing entities have faced challenges in trying to ensure that accounting and financial reporting requirements appropriately meet the needs of investors and other financial market participants.</p>
 <p>Financial markets have become increasingly global in nature, and regulators have had to coordinate their efforts internationally.</p>	<p>Standard setters and regulators also face new challenges in dealing with global convergence of accounting and auditing standards.</p> <p>Fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators, such as negotiations on Basel II and certain insurance matters.</p>

Sources: GAO (analysis); Art Explosion (images).

Regulators have struggled, and often failed, to identify the systemic risks posed by large and interconnected financial conglomerates, as well as new and complex products, and to adequately manage these risks. These firms' operations increasingly cross financial sectors, but no single regulator is tasked with assessing the risks such an institution might pose across the entire financial system. In addition, regulators have had to address problems in financial markets resulting from the activities of sometimes less-regulated and large market participants—such as nonbank mortgage lenders, hedge funds, and credit rating agencies—some of which play significant roles in today's financial markets. Further, the increasing prevalence of new and more complex financial products has challenged regulators and investors, and consumers have faced difficulty understanding new and increasingly complex retail mortgage and credit products. Standard setters for accounting and financial regulators have also faced growing challenges in ensuring that accounting and audit standards appropriately respond to financial market developments. And despite the increasingly global aspects of financial markets, the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

Because of this hearing's focus on prudential regulation of the banking industry, I would like to reinforce that our prior work has repeatedly identified limitations of the fragmented banking regulatory structure. For example:

- In 1996, we reported that the division of responsibilities among the four federal bank oversight agencies in the United States was not based on specific areas of expertise, functions or activities, either of the regulator or the banks for which they are responsible, but based on institution type and whether the banks were members of the Federal Reserve System. Despite their efforts to coordinate, this multiplicity of regulators was cited as resulting in inconsistent treatment of banking institutions in examinations, enforcement actions, and regulatory decisions.⁴
- In a 2007 report we noted that having bank holding company affiliates supervised by multiple banking regulators increased the potential for conflicting information to be provided to the institution, such as when a large, complex banking organization initially received conflicting information from the Federal Reserve, its consolidated supervisor, and

⁴GAO, *Bank Oversight Structure: U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure*, GAO/GGD-97-23 (Washington D.C.: Nov. 20, 1996).

OCC, its primary bank supervisor, about the firm's business continuity provisions.⁵

- In 2005, we reported that a difference in authority across the banking regulators could lead to problems in oversight. For example, FDIC's authority over the holding companies and affiliates of industrial loan corporations was not as extensive as the authority that the other supervisors have over the holding companies and affiliates of banks and thrifts. For example, FDIC's authority to examine an affiliate of an insured depository institution exists only to disclose the relationship between the depository institution and the affiliate and the effect of that relationship on the depository institution. Therefore, any reputation or other risk from an affiliate that has no relationship with the industrial loan corporation could go undetected.⁶
- In a 2004 report, we noted cases in which interagency cooperation between bank regulators has been hindered when two or more agencies share responsibility for supervising a bank. For example, in the failure of Superior Bank of West Virginia problems between OTS, Superior's primary supervisor, and FDIC hindered a coordinated supervisory approach, including OTS refusing to let FDIC participate in at least one examination. Similarly, disagreements between OCC and FDIC contributed to the 1999 failure of Keystone Bank.⁷
- In a 2007 report, we expressed concerns over the appropriateness of having OTS oversee diverse global financial firms given the size of the agency relative to the institutions for which it was responsible.⁸

Our recent work has further revealed limitations in the current regulatory system, reinforcing the need for change and the need for an entity responsible for identifying existing and emerging systemic risks. In

⁵GAO, *Financial Market Regulation: Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration*, GAO-07-154 (Washington, D.C.: Mar. 15, 2007).

⁶GAO, *Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority*, GAO-05-621 (Washington, D.C.: Sept. 15, 2005).

⁷GAO, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO-05-61 (Washington, D.C.: Oct. 6, 2004).

⁸GAO-07-154.

January 2009, we designated modernizing the outdated U.S. financial regulatory system as a new high-risk area to bring focus to the need for a broad-based systemwide transformation to address major economy, efficiency, and effectiveness challenges.⁹ We have found that:

- Having multiple regulators results in inconsistent oversight. Our February 2009 report on the Bank Secrecy Act found that multiple regulators are examining for compliance with the same laws across industries and, for some larger holding companies, within the same institution.¹⁰ However, these regulators lack a mechanism for promoting greater consistency, reducing unnecessary regulatory burden, and identifying concerns across industries. In July 2009, we reported many violations by independent mortgage lenders of the fair lending laws intended to prevent lending discrimination could go undetected because of less comprehensive oversight provided by various regulators.¹¹
- Lack of oversight exists for derivatives products. In March 2009, we reported that the lack of a regulator with authority over all participants in the market for credit default swaps (CDS) has made it difficult to monitor and manage the potential systemic risk that these products can create.¹²
- Gaps in the oversight of significant market participants. We reported in May 2009 on the issues and concerns related to hedge funds, which have grown into significant market participants with limited regulatory oversight.¹³ For example, under the existing regulatory structure, SEC's ability to directly oversee hedge fund advisers is limited to those that are required to register or voluntarily register with the SEC as an investment advisor. Further, multiple regulators (SEC, CFTC, and federal banking regulators) each oversee certain hedge fund-related activities and advisers.

⁹GAO-09-227.

¹⁰GAO, *Bank Secrecy Act: Federal Agencies Should Take Action to Further Improve Coordination and Information-Sharing Efforts*, GAO-09-227 (Washington, D.C.: Feb. 12, 2009).

¹¹GAO, *Fair Lending: Data Limitations and the Fragmented U.S. Financial Regulatory Structure Challenge Federal Oversight and Enforcement Efforts*, GAO-09-704 (Washington, D.C.: Jul. 15, 2009).

¹²GAO, *Systemic Risk: Regulatory Oversight and Recent Initiatives to Address Risk Posed by Credit Default Swaps*, GAO-09-397T (Washington, D.C.: Mar. 5, 2009).

¹³GAO, *Hedge Funds: Overview of Regulatory Oversight, Counterparty Risks, and Investment Challenges*, GAO-09-677T (Washington, D.C.: May 7, 2009).

We concluded that given the recent experience with the financial crisis, regulators should have the information to monitor the activities of market participants that play a prominent role in the financial system, such as hedge funds, to protect investors and manage systemic risk.

- Lack of appropriate resolution authorities for financial market institutions. We recently reported that one of the reasons that federal authorities provided financial assistance to at least one troubled institution—the insurance conglomerate AIG—in the crisis stemmed from concerns that a disorderly failure by this institution would have contributed to higher borrowing costs and additional failures, further destabilizing fragile financial markets. According to Federal Reserve officials, the lack of a centralized and orderly resolution mechanism presented the Federal Reserve and Treasury with few alternatives in this case. The lack of an appropriate resolution mechanism for non-banking institutions has resulted in the federal government providing assistance and having significant ongoing exposure to AIG.
- Lack of a focus on systemwide risk. In March 2009 we also reported on the results of work we conducted at some large, complex financial institutions that indicated that no existing U.S. financial regulator systematically looks across institutions to identify factors that could affect the overall financial system.¹⁴ While regulators periodically conducted horizontal examinations on stress testing, credit risk practices, and risk management, they did not consistently use the results to identify potential systemic risks and have only a limited view of institutions' risk management or their responsibilities. Our July 2009 report on approaches regulators used to restrict the use of financial leveraging—the use of debt or other products to purchase assets or create other financial exposures—by financial institutions also found that regulatory capital measures did not always fully capture certain risks and that none of the multiple regulators responsible for individual markets or institutions had clear responsibility to assess the potential effects of the buildup of systemwide leverage.¹⁵

¹⁴GAO, *Financial Regulation: Review of Regulators' Oversight of Risk Management Systems at a Limited Number of Large, Complex Financial Institutions*, GAO-09-499T (Washington, D.C.: Mar. 18, 2009).

¹⁵GAO, *Financial Markets Regulation: Financial Crisis Highlights Need to Improve Oversight of Leverage at Financial Institutions and across System*, GAO-09-739 (Washington, D.C.: Jul. 22, 2009).

Recognition of the need for regulatory reform extends beyond U.S. borders. Various international organizations such as the G20, G30, Bank for International Settlements, and Committee on Capital Markets Regulation have all reported that weaknesses in regulation contributed to the financial crisis.¹⁶ Specifically, among other things, these reports pointed to the fragmented regulatory system, the lack of a systemwide view of risks, and the lack of transparency or oversight of all market participants as contributing to the crisis. Further, the reports noted that sound regulation and a systemwide focus were needed to prevent instability in the financial system, and that recent events have clearly demonstrated that regulatory failures had contributed to the current crisis.

**Other Countries Have
Adopted Various
Structures for Their
Regulatory Systems,
but the Recent Crisis
Is Prompting
Additional Changes**

In response to consolidation in the financial services industry and past financial crises, other countries have previously made changes to their financial regulatory systems in the years before the most recent crisis. For the purposes of our study, we selected five countries—Australia, Canada, Sweden, the Netherlands, and the United Kingdom—that had sophisticated financial systems and different regulatory structures. Each of these countries restructured their regulatory systems within the last 20 years in response to market developments or financial crises (see table 1).

¹⁶G-20 Working Group 1, *Enhancing Sound Regulation and Strengthening Transparency*, March 25, 2009 and Bank for International Settlements, *79th Annual Report* (Basel, Switzerland, Jun. 12, 2009). The Group of 30, *Financial Reform: A Framework for Financial Stability* (Washington, D.C.: Jan. 15, 2009). Committee on Capital Markets Regulation, *The Global Financial Crisis, A Plan for Regulatory Reform* (May 2009).

Table 1: Examples of Regulatory Changes

Country & Regulatory Structure	Response to the Crisis	Examples of Actions Taken or Contemplated
Australia - Separate regulator for prudential oversight and a separate consumer protection agency that oversees conduct of business. Responsibility for systemic stability, the payment system, and monetary policy is with the central bank.	The government expressed willingness to purchase residential mortgage backed securities. Retail deposits up to AUD \$1 million were guaranteed—previously the limit was AUD \$20,000.	<ul style="list-style-type: none"> Reviewing liquidity standards and risk management approaches for banks.
Canada - Single prudential supervisor for banks insurance companies, and pension plans. A separate agency oversees consumer protection for banking. Securities regulation is conducted at the provincial level. The central bank is the lender of last resort.	Banks have accessed liquidity facilities provided by the central bank. Government agency has purchased residential mortgages from banks.	<ul style="list-style-type: none"> Reexamining the quality of bank capital, the effect of relying on wholesale funding, the risks posed by off balance sheet exposures, the role of credit rating agencies, and the need for improved international solvency resolution.
The Netherlands - The prudential and systemic risk supervisor of all financial services is the central bank. A separate conduct of business regulator also is responsible for consumer protection.	The government took over the Dutch operations of an internationally active bank. Other banks were given solvency assistance and the government also took on the high risk mortgage portfolios of other banks.	<ul style="list-style-type: none"> Will strengthen capital requirements. Will strengthen supervisory authorities. Will address systemic risk nationally.
Sweden - A single regulator covers banking, securities, and insurance. Sweden's central bank conducts monetary policy and is entrusted with promoting safe and efficient payment systems.	The government approved a debt guarantee scheme for the medium term borrowing of banks and mortgage institutions. Bank deposit insurance limits were increased. One domestic bank failed and was resolved.	<ul style="list-style-type: none"> The government enacted legislation giving it the power to grant credit guarantees if there is a serious systemic risk and bank capital falls below a regulatory threshold. Changes are being contemplated in the prompt corrective action framework, the deposit insurance scheme, cross border crisis resolution.
United Kingdom - A single agency deals with banking, insurance, asset management and market supervision and regulation. The central bank exercised informal oversight over the banking sector.	The government created a bank recapitalization fund, a credit guarantee scheme, and special liquidity scheme, and an asset protection scheme.	<p>Reform of the regulatory and legislative framework will:</p> <ul style="list-style-type: none"> reform the corporate governance of banking institutions, change the amount of capital firms will need, reduce their leverage, more intensive regulation of financial firms, and new powers for authorities to deal with failing banks.

Source: GAO analysis.

soundness and business conduct regulation.¹⁷ A single regulator is viewed by some as advantageous because, with financial firms not being as specialized as they used to be, a single regulator presents economies of scale and efficiency advantages, can quickly resolve conflicts that arise between regulatory objectives, and the regulatory model increases accountability. For example, the United Kingdom moved to a more integrated model of financial services regulation because it recognized that major financial firms had developed into more integrated full services businesses. As a result, this country created one agency (Financial Services Authority) to deal with banking, insurance, asset management and market supervision and regulation. Similarly, Canada and Sweden integrated their regulatory systems prior to the current global financial crisis.

In contrast, other countries chose to follow a twin peaks model. The twin peaks model is viewed by some as advantageous because they view the two principal objectives of financial regulation—systemic protection and consumer protection—as being in conflict. Putting these objectives in different agencies institutionalizes the distinction and ensures that each agency focuses on one objective. For example, in order to better regulate financial conglomerates and minimize regulatory arbitrage, Australia created one agency responsible for prudential soundness of all deposit taking, general and life insurance, and retirement pension funds (Australian Prudential Regulatory Authority) and another for business conduct regulation across the financial system including all financial institutions, markets, and market participants (Australian Securities and Investment Commission). In the Netherlands, regulators were divided along the lines of banking, insurance, and securities until the twin peaks approach was adopted. Under the revised structure, the prudential and systemic risk supervisor of all financial services including banking, insurance, pension funds, and securities is the central bank (DNB). Another agency (Netherlands Authority for Financial Markets) is responsible for conduct of business supervision and promoting transparent markets and processes to protect consumers.

However, regardless of the regulatory system structure, these and many other countries were affected to some extent by the recent financial crisis. For example, the United Kingdom experienced bank failures, and the

¹⁷While we chose countries that use the integrated and twin peaks approaches, other approaches to financial regulation exist.

government provided financial support to financial institutions. Further, in the Netherlands, where the twin peaks approach is used, the government took over the operations of one bank, provided assistance to financial institutions to reinforce their solvency positions, and took on the risk of a high-risk mortgage portfolio held by another bank, among other actions.

However, regulators or financial institutions in some of these countries took steps that may have reduced the impact of the crisis on their institutions. For example, according to a testimony that we reviewed, the impact on Australian institutions was mitigated by the country's relatively stricter prudential standards compared to other countries. The Australian prudential regulator had also conducted a series of stress tests on its five largest banks that assessed the potential impact of asset price changes on institutions. According to Canadian authorities, the positive performance of Canadian banks relative to banks in other countries in the recent crisis was the result of a more conservative risk appetite that limited their activities in subprime mortgages, and exotic financial instruments. However, both countries still experienced some turbulence, requiring among other actions, some government purchases of mortgage-backed securities by the Australian government and some Canadian banks taking advantage of liquidity facilities provided by the Bank of Canada.

Authorities in these five countries have taken actions or are contemplating additional changes to their financial regulatory systems based on weaknesses identified during the current financial crisis. These changes included strengthening bank capitalization requirements, enhancing corporate governance standards, and providing better mechanisms for resolving failed financial institutions. For example, in the United Kingdom, in response to its experience dealing with one large bank failure (Northern Rock) the government has called for strengthening the role of the central bank. The Banking Act of 2009 formalized a leading role for the Bank of England in resolving financial institution and provided it statutory authority in the oversight of systemically important payment and settlement systems.

Reform Proposals Would Enhance U.S. Regulatory System, but Additional Opportunities to Improve System Appear to Exist

With a clear need to improve regulatory oversight, our January 2009 report offered a framework for crafting and evaluating regulatory reform proposals.¹⁸ This framework includes nine characteristics that should be reflected in any new regulatory system, including:

- goals that are clearly articulated and relevant, so that regulators can effectively conduct activities to implement their missions.
- appropriately comprehensive coverage to ensure that financial institutions and activities are regulated in a way that ensures regulatory goals are fully met;
- a mechanism for identifying, monitoring, and managing risks on a systemwide basis, regardless of the source of the risk or the institution in which it is created;
- an adaptable and forward-looking approach allows regulators to readily adapt to market innovations and changes and evaluate potential new risks;
- efficient oversight of financial services by, for example, eliminating overlapping federal regulatory missions, while effectively achieving the goals of regulation;
- consumer and investor protection as part of the regulatory mission to ensure that market participants receive consistent, useful information, as well as legal protections for similar financial products and services, including disclosures, sales practices standards, and suitability requirements;
- assurance that regulators have independence from inappropriate influence; have sufficient resources and authority, and are clearly accountable for meeting regulatory goals;
- assurance that similar institutions, products, risks, and services are subject to consistent regulation, oversight, and transparency; and
- adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk.

Various organizations have made proposals to reform the U.S. regulatory system, and several proposals have been introduced to the Congress. Among these proposals are the administration's proposal, which is specified in its white paper and draft legislation, and another proposal that

¹⁸GAO-09-216.

has been introduced as legislation in the House of Representatives (H.R. 3310).¹⁹

The administration's proposal includes various elements that could potentially improve federal oversight of the financial markets and better protect consumers and investors. For example, it establishes a council consisting of federal financial regulators that would, among other things, advise Congress on financial regulation and monitor the financial services market to identify the potential risks systemwide. Under H.R. 3310, a board consisting of federal financial regulators and private members, would also monitor the financial system for exposure to systemic risk and advise Congress. The creation of such a body under either proposal would fill an important need in the current U.S. regulatory system by establishing an entity responsible for helping Congress and regulators identify potential systemic problems and making recommendations in response to existing and emerging risks. However, such an entity would also need adequate authority to ensure that actions were taken in response to its recommendations. As discussed, the inability of regulators to take appropriate action to mitigate problems that posed systemic risk contributed to the current crisis.

The administration's proposal also contains measures to improve the consistency of consumer and investor protection. First, the administration proposes to create a new agency, the Consumer Financial Protection Agency (CFPA). Among other things, this agency would assume the consumer protection authorities of the current banking regulators and would have broad jurisdiction and responsibility for protecting consumers of credit, savings, payment and other consumer financial products and services. Its supervisory and enforcement authority generally would cover all persons subject to the financial consumer protection statutes it would be charged with administering. However, the SEC and CFTC would retain their consumer protection role in securities and derivatives markets. As our January report described, consumers have struggled with understanding complex products and the multiple regulators responsible for overseeing such issues have not always performed effectively. We urged that a new regulatory system be designed to provide high-quality,

¹⁹ *A NEW FOUNDATION: Rebuilding Financial Supervision and Regulation* provides outlines the Administration's proposal and draft legislation provides additional specific information. Mr. Spencer Bachus and others introduced H.R. 3310, the Consumer Protection and Regulatory Enhancement Act of 2009—a proposal on behalf of House Republicans—on July 23, 2009.

effective, and consistent protection for consumers and investors in similar situations. The administration's proposal addresses this need by charging a single financial regulatory agency with broad consumer protection responsibilities. This approach could improve the oversight of this important issue and better protect U.S. consumers. However, separating the conduct of consumer protection and prudential regulation can also create challenges. Therefore, having clear requirements to coordinate efforts across regulators responsible for these different missions would be needed.

Although the Administration's proposal would make various improvements in the U.S. regulatory system, our analysis indicated that additional opportunities exist to further improve the system exist. Unlike H.R. 3310, which would combine all five federal depository institution regulators, the Administration's proposal would only combine the current regulators for national banks and thrifts into one agency, leaving the three other depository institution regulators—the Federal Reserve, the FDIC, and NCUA—to remain separate. As we reported in our January 2009 report, having multiple regulators performing similar functions presents challenges.³⁰ For example, we found that some regulators lacked sufficient resources and expertise, that the need to coordinate among multiple regulators slowed responses to market events, and that institutions could take advantage of regulatory arbitrage by seeking regulation from an agency more likely to offer less scrutiny. Regulators that are funded by assessments on their regulated entities can also become overly dependent on individual institutions for funding, which could potentially compromise their independence because such firms have the ability to choose to be overseen by another regulator.

Finally, regardless of any regulatory reforms that are adopted, we urge Congress to continue to actively monitor the progress of such implementation and to be prepared to make legislative adjustments to ensure that any changes to the U.S. financial regulatory system are as effective as possible. In addition, we believe that it is important that Congress provides for appropriate GAO oversight of any regulatory reforms to ensure accountability and transparency in any new regulatory system. GAO stands ready to assist the Congress in its oversight capacity and evaluate the progress agencies are making in implementing any changes.

³⁰GAO-09-216.

Mr. Chairman and Members of the Committee, I appreciate the opportunity to discuss these critically important issues and would be happy to answer any questions that you may have. Thank you.

Staff Contributions and Acknowledgments

For further information on this testimony, please contact Orice Williams Brown at (202) 512-8678 or williamsob@gao.gov, or Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include Cody J. Goebel, Assistant Director; Sonja J. Bensen; Emily R. Chalmers, Patrick S. Dynes; Marc W. Molino; Jill M. Naamane; and Paul Thompson.

Appendix I: Framework for Crafting and Evaluating Regulatory Reform

<p>As a result of significant market developments in recent decades that have outpaced a fragmented and outdated regulatory structure, significant reforms to the U.S. regulatory system are critically and urgently needed. The following framework consists of nine elements that should be reflected in any new regulatory system. This framework could be used to craft proposals, or to identify aspects to be added to existing proposals to make them more effective and appropriate for addressing the limitations of the current system.</p>	
Characteristic	Description
Clearly defined regulatory goals	Goals should be clearly articulated and relevant, so that regulators can effectively carry out their missions and be held accountable. Key issues include considering the benefits of re-examining the goals of financial regulation to gain needed consensus and making explicit a set of updated comprehensive and cohesive goals that reflect today's environment.
Appropriately comprehensive	Financial regulations should cover all activities that pose risks or are otherwise important to meeting regulatory goals and should ensure that appropriate determinations are made about how extensive such regulations should be, considering that some activities may require less regulation than others. Key issues include identifying risk-based criteria, such as a product's or institution's potential to create systemic problems, for determining the appropriate level of oversight for financial activities and institutions, including closing gaps that contributed to the current crisis.
Systemwide focus	Mechanisms should be included for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk. Given that no regulator is currently tasked with this, key issues include determining how to effectively monitor market developments to identify potential risks; the degree, if any, to which regulatory intervention might be required; and who should hold such responsibilities.
Flexible and adaptable	A regulatory system that is flexible and forward looking allows regulators to readily adapt to market innovations and changes. Key issues include identifying and acting on emerging risks in a timely way without hindering innovation.
Efficient and effective	Effective and efficient oversight should be developed, including eliminating overlapping federal regulatory missions where appropriate, and minimizing regulatory burden without sacrificing effective oversight. Any changes to the system should be continually focused on improving the effectiveness of the financial regulatory system. Key issues include determining opportunities for consolidation given the large number of overlapping participants now, identifying the appropriate role of states and self-regulation, and ensuring a smooth transition to any new system.
Consistent consumer and investor protection	Consumer and investor protection should be included as part of the regulatory mission to ensure that market participants receive consistent, useful information, as well as legal protections for similar financial products and services, including disclosures, sales practice standards, and suitability requirements. Key issues include determining what amount, if any, of consolidation of responsibility may be necessary to streamline consumer protection activities across the financial services industry.
Regulators provided with independence, prominence, authority, and accountability	Regulators should have independence from inappropriate influence, as well as prominence and authority to carry out and enforce statutory missions, and be clearly accountable for meeting regulatory goals. With regulators with varying levels of prominence and funding schemes now, key issues include how to appropriately structure and fund agencies to ensure that each one's structure sufficiently achieves these characteristics.

Characteristic	
Consistent financial oversight	Similar institutions, products, risks, and services should be subject to consistent regulation, oversight, and transparency, which should help minimize negative competitive outcomes while harmonizing oversight, both within the United States and internationally. Key issues include identifying activities that pose similar risks, and streamlining regulatory activities to achieve consistency.
Minimal taxpayer exposure	A regulatory system should foster financial markets that are resilient enough to absorb failures and thereby limit the need for federal intervention and limit taxpayers' exposure to financial risk. Key issues include identifying safeguards to prevent systemic crises and minimizing moral hazard.

Source: GAO

Related GAO Products

Financial Markets Regulation: Financial Crisis Highlights Need to Improve Oversight of Leverage at Financial Institutions and across System. GAO-09-739. Washington, D.C.: Jul. 22, 2009.

Fair Lending: Data Limitations and the Fragmented U.S. Financial Regulatory Structure Challenge Federal Oversight and Enforcement Efforts. GAO-09-704. Washington, D.C.: Jul. 15, 2009.

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