STATEMENT OF
THE FINANCIAL SERVICES ROUNDTABLE
On
REGULATORY RESTRUCTURING: BALANCING THE INDEPENDENCE OF THE FEDERAL RESERVE IN MONETARY POLICY WITH SYSTEMIC RISK REGULATION
Before the
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY AND TECHNOLOGY
FINANCIAL SERVICES COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES
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Chairman Watt, Ranking Member Paul, and Members of the Subcommittee on Domestic Monetary Policy and Technology, the Financial Services Roundtable appreciates this opportunity to submit this statement for the record. The Roundtable is a national trade association composed of the nation's largest diversified banking, securities, and insurance companies. Our members provide the full range of financial products and services to every kind of consumer and business.

The Roundtable supports the urgent need for bold and comprehensive regulatory reform of financial services. We need to be mindful of lessons learned from the worst financial crisis in our lifetime, but we also need to be forward-looking and rebuild our financial regulation and regulatory architecture to ensure in the longer term that U.S. financial markets and firms are the most competitive and innovative in the world consistent with high standards for risk management and good governance. Financial services firms must be well positioned to meet the needs of their customers, support sustained economic recovery and growth, and provide a foundation to create new jobs. Any reforms enacted by Congress and signed by the President must be mindful of this simple economic imperative.

The Obama Administration has put forward a thoughtful proposal for regulatory reform, its New Foundation. The Treasury Department's white paper released on June 17, 2007, is a positive contribution to the current public policy debate. Specifically, we support the creation of a new Financial Services Coordinating Council (Council) and designating the Federal Reserve as what we prefer to call a market stability oversight authority (authority); in both cases, we recommend several changes to strengthen the Administration's proposal.

The Roundtable has testified numerous times in 2008 and 2009 on both the market and regulatory failures exposed by the financial crisis; this statement, therefore, will dispense with reciting that testimony again today. Instead, this statement will focus on three points that are directly relevant to your inquiry: 1) the Roundtable's detailed position on the need for better oversight and surveillance of systemic risk by the U.S. Government as one important part of regulatory reform; 2) the need for clear objectives and principles for our financial system to support our economy as a starting point for regulatory reform; and 3) the need for a new regulatory architecture for our financial system that fully supports stable economic growth and serves consumers. Since we only have analyzed the Treasury's white paper, we reserve the right to provide additional testimony when the detailed draft legislation on systemic risk is sent to Congress.

1. THE NEED TO LIMIT AND MITIGATE SYSTEMIC RISK

As a practical matter, we believe that "systemic risk" should be defined as an activity or practice that crosses financial markets or financial services firms, and which, if left unaddressed, would have a significant, material adverse effect on financial services firms, financial markets, or the U.S. economy. Risk is inherent in all competitive financial markets – banking, insurance, and securities. It is part of the intermediation process between providers and users of all financial services. It needs to be managed first at the institution level as well as at the systemic level to the extent possible, recognizing that no Government will be able to fully protect open and competitive markets from all financial stress and even occasional panic in the future.

After a brief review of why the Roundtable believes a market stability oversight authority is necessary, we analyze two important parts of the Administration's New Foundation: the creation of a permanent Financial Services Coordinating Council and the designation of the Federal Reserve as the market stability oversight authority.

Why do we need a systemic risk regulator?

The activities and practices of U.S. financial markets are interconnected, nationally and internationally. Banks, broker-dealers, insurance companies, finance companies, hedge funds, and other regulated and unregulated financial services firms are continuously and mutually engaged in a variety of lending, investment, trading, and other financial transactions. Yet, under our existing financial regulatory structure, no single agency has the authority to look across all sectors of the financial services industry and all markets to evaluate risks posed by these interconnections.

While often it is assumed that some combination of the U.S. Treasury Department (Treasury) and the Federal Reserve Board (Federal Reserve) are responsible for broad financial market stability, neither the Treasury nor the Federal Reserve has the explicit mandate and the full arsenal of supervisory authorities to promote market stability and prevent systemic risk across different company charters and products. Different regulators are responsible for the different silos they oversee; no single agency looks at the entire financial system serving consumers and our economy.

Prior to 2008, the only authority the Secretary of the Treasury (Secretary) had to look at the financial markets as a whole was the authority delegated to the Secretary by the President (through an Executive Order) in 1988 to chair and convene the President's Working Group on Financial Markets (PWG). The PWG could only ask regulators to cooperate on key issues and issue occasional reports. In 1991, the Congress gave the Secretary a pivotal role in the implementation of the systemic risk exception to the FDIC's least-cost resolution process. Under that process, the Secretary, in consultation with the President, must agree that paying uninsured depositors or creditors "would have serious adverse effects on economic conditions or financial stability" and as such, the FDIC would have the power to intervene in the market to address systemic risk. Yet, the FDIC Improvement Act did not give the Secretary any additional responsibilities, either to determine what constitutes systemic risk, to more closely monitor systemically relevant institutions, or to make any detailed reports about its analysis when this exemption is invoked.

The Federal Reserve plays multiple roles in financial markets, but also does not have an explicit market stability mandate or clearly defined role to identify and prevent systemic risk to U.S. financial markets. As the nation's central bank, it has broad monetary policy tools to promote price stability and full employment in the U.S. economy. It oversees part of the U.S. payments system, but not all. It regulates and supervised state-member banks at the national level, but not national banks, which are regulated by the OCC or state nonmember banks, which are regulated by the FDIC. It regulates and supervises all bank and financial holding companies, but not thrift holding companies, which are regulated and supervised by the OTS, or investment bank holding companies, which are supervised by the SEC. It lends to financial institutions through normal discount window operations. Starting in 2008 during the current crisis, the Federal Reserve greatly expanded its emergency lending to financial institutions and others using its authority to lending in Section 13(3) during "unusual and exigent circumstances." But even in these roles, the Federal Reserve's market stability activities are confined mainly to *reactive* actions and financing vehicles under its unique lending powers.

The missing link is a single federal authority with the mandate, responsibility, and expertise to oversee the nation's entire financial system, not just its individual parts, and to promote market stability while preventing systemic risk for firms that operate in this global marketplace. This would resolve the regulatory redundancy that currently creates the gaps in oversight.

Why the Federal Reserve as a market stability oversight authority?

From the Roundtable's perspective, the U.S. financial system does not need another layer of regulation and a new bureaucracy on top of the current structure. What we do need, however, is better surveillance of interconnected activities and practices among all providers of financial services across the financial system, not another super-regulator of individual institutions. As such, we support and prefer the nuanced designation of a new Market Stability Oversight Authority that is the Federal Reserve, without making the Federal Reserve a super-regulator and without drawing a "bright line" around a set of providers publically designated as "systemically important". This nuance is explained in greater detail below.

Designating the Federal Reserve is a natural complement to the Board's existing role as the nation's central bank and lender of last resort. However, we recognize that this new role would require the Board to expand its staff to include experts in all types of financial activities, practices, and markets. Also, if the Board is given this new authority, it would need to establish a clear and transparent governance structure internally to minimize any potential conflicts with its existing responsibilities. Rigorous Congressional oversight of this new role will be critical.

Furthermore, we would recommend that the Board establish an Advisory Council on Market Stability to review activities and practices that may pose a systemic risk, balanced against the need for continuing market innovation and competitiveness. The Advisory Council should include representatives of domestic and international financial services firms doing business in the United States as well as representatives of consumers of financial services.

What is the role of a market stability oversight authority?

The purpose of a market stability oversight authority should be to promote the long-term stability and integrity of the nation's financial markets and financial services firms by identifying and addressing significant risks to the financial system as a whole.

This new authority should be authorized to oversee all types of all financial markets and all financial services firms, whether regulated or unregulated. However, a market stability authority should **not** focus on financial services firms based upon size. The designation of "systemically significant financial services firms" would have unintended competitive consequences and increase moral hazard as these firms would be deemed too big to fail.

The authority should **not** be just another layer of regulation added to the existing system; it should **not** be a "super-regulator". Absent an immediate, systemic threat, it should be required to work with and through other financial regulators, including a national insurance regulator. Also, a national insurance regulator is needed to give the federal government a better understanding and role in the supervision of this key part of our nation's financial services sector.

Congress, by statute, should require this new authority to balance the identification of activities or practices that pose a systemic risk against the need for continuing market innovation and competitiveness. This new responsibility should <u>not</u> stifle innovation, or preclude isolated failures. Failures in a market-based economic system are a fact of life and should be resolved in an orderly manner across all financial services. Innovation is a key to economic growth and new job creation.

Congress also should direct this new authority to focus attention on factors that present the greatest potential for systemic risk, such as excessive concentrations of assets or liabilities, rapid growth in assets or liabilities, high leverage, a mismatch between long-term assets and short-term liabilities, currency mismatch, and regulatory gaps. This authority should **not** focus attention on products or practices that pose little or no systemic risk.

How would this new authority function?

The authority should identify, prevent, and mitigate systemic risk by –

- Collecting and analyzing data from other financial regulators and individual financial services firms to understand potential or existing systemic risks in the financial system. Data on individual firms should be treated as confidential supervisory information;
- Establishing a surveillance system for activities and practices to detect early crisis warning signs and vulnerabilities, conduct scenario planning, and develop contingency planning with other prudential financial regulators across all financial markets;
- Examining individual financial services firms when a systemic risk is apparent. If a firm is engaged in activities and practices that are a threat to market stability and regulated by another national or state financial regulator, such examinations should be limited and coordinated with such regulator. Examination results should be treated as confidential supervisory information;
- Issuing, as necessary, reports and public notices on activities or practices that may pose a systemic risk;

- Working closely with other international authorities to ensure a global perspective on financial markets and potential systemic risk; and
- Taking corrective actions to prevent or address systemic risk.

To help prevent this authority from becoming a "super-regulator", we would recommend that, absent an emergency situation, the market stability regulator should take actions through other primary regulators. In other words, in non-emergency times, the market stability authority should be authorized to make recommendations to other regulators, the new Coordinating Council, and/or Congress to address activities and practices that could pose a potential systemic risk, but do not pose an immediate systemic threat to markets or the economy.

Whenever this new authority identifies a practice or activity that could pose a systemic risk and such practice or activity is within the jurisdiction of another national or state financial regulator, then it should issue a finding and recommend appropriate preventive actions to the other regulator. It also should submit any such findings and recommendations to the Administration's new Council and/or to the Congress. If another regulator disagrees with the authority's finding and recommendation, then the regulator can submit its own findings and recommendations to the new Council or this Congress.

If the new authority identifies an activity or practice that could pose a systemic risk, and such activity or practice is not subject to regulation or supervision by another regulator – a clear regulatory gap – then it should make a recommendation to Congress on how best to regulate and supervise such activity or practice in the future to close the regulatory gap.

The authority should be granted the ability to take unilateral actions only in the most limited situations to address significant activities or practices and only when the authority determines that they pose an immediate, systemic risk, which could not be addressed in a timely fashion if the authority were to recommend actions by any other regulator. Such unilateral actions would include the power to issue orders or regulations affecting activities or practices of individual firms or categories of firms. Such unilateral actions should only be approved by a super-majority of the members of the Federal Reserve Board, and should be agreed to by the Secretary of the Treasury, who must consult with the President. Such unilateral actions also should be reported immediately to Congress. This authority would be in addition to the Board's existing authority under section 13(3) of the Federal Reserve Act to make extend credit to financial or non-financial institutions in "unusual and exigent" circumstances. The Board should retain that authority, with full and timely public disclosure every time this authority is used.

If market stability oversight authority had been in place before this crisis, how would it have impacted the crisis?

We should not expect a market stability oversight authority to identify all potential systemic risks and eliminate the potential for any crisis in a competitive, market-based, global economy. In fact, some level of risk is inherent in all financial systems by definition. As noted earlier, any new authority should be required explicitly by Congress to balance risk mitigation and innovation to serve all consumers better in the future and meet all the financing needs of the economy.

That said, there are a couple of activities or practices that this new authority could have flagged, and, if such activities and practices had been adjusted, the current crisis should have been identified earlier and as a result could have been less severe. First, it is now clear that one of the practices that contributed to the current crisis was excessive leverage by large financial services firms, especially investment banks. This new authority as the Roundtable envisions could have identified this leverage as a potential warning sign sooner and urged the SEC to take corrective actions. Has the SEC not acted, the authority could have taken its case to the new Coordinating Council for a full inter-agency review and debate.

Another practice that contributed to the current crisis was growth in non-traditional mortgage instruments. A new oversight authority might have seen this and recognized the value of these innovations for certain consumers, as well as the risk to other consumers who were at risk from no documentation, no money down, adjustable rate loans. This new authority then could have recommended new uniform, national standards for such products long before the banking agencies acted on their own joint guidance.

Managing systemic risk better in the future

There are two major and inter-related components in the Administrations proposal that will help to prevent and mitigate systemic risk in the future, recognizing that no architectural design is a guarantee against all future financial crises. The first is the Administration's proposal to create a new Financial Services Oversight Council, which is modeled on the Roundtable's 2007 proposal. The second is making the Federal Reserve responsible for the promotion of market stability and the prevention of systemic risk. We support both of these improvements to the U.S, financial regulatory architecture with some further refinements to strengthen what has been proposed by the Administration. We reserve the right to recommend additional changes once the Administration sends Congress draft legislation.

Financial Services Oversight Council. The Roundtable has been a consistent advocate of better regulatory coordination and cooperation since our 2007 Blueprint on Financial Modernization. We called for the codification of an enhanced and expanded President's Working Group on Financial Markets (PWG) with all regulators having a seat at the table, including representatives of state regulated industries (banking, insurance, securities).

Therefore, we generally support the creation of a new Financial Services Oversight Council along the lines described in the Treasury's report, with four additional suggestions: 1) a new National Insurance Supervisor for all insurance companies opting or mandated by Congress to have a national insurance charter to serve their customers nationally or internationally should also have a seat on the new Council; a new national insurance regulator is needed to give the federal government a better understanding and role in the systemic supervision of a key part of our nation's financial services sector; 2) representatives of state banking, insurance, and securities regulators also should be included; 3) as part of a more forward looking mandate, the Council should also monitor the adherence to whatever principles Congress legislates to guide financial regulation and preferred regulatory outcomes in the future; and 4) each regulatory agency should develop comprehensive regulatory action plans to review the costs and benefits of each regulation under an agency's purview; in turn, these regulatory action plans would be presented and reviewed by the Council on an ongoing basis to ensure regulations are as effective and efficient as possible in serving their intended purpose.

Market Stability Oversight Authority. There clearly is a need for a market stability or systemic risk oversight authority to look across all financial markets and try to identify and then mitigate potential threats of systemic risk from activities and practices before they undermine market stability. The Roundtable supports the Administration's position that the Federal Reserve should play this role of greater market surveillance, leading the effort to set new standards for capital, liquidity, and risk management, and then working with other regulators to prevent a systemic collapse or another financial panic in the future. In this capacity, the Federal Reserve should focus primarily on the activities and practices by firms that may pose a risk to the economy across markets, while leaving the regulation and supervision of individual firms to their primary regulator under the new system. We also support the addition of a private-sector Advisory Council on Market Stability as noted above.

From our perspective, there is no need to create an artificial distinction of a Tier 1 Financial Holding Company (FHC), as proposed by the Administration, if the new standards we are setting for all financial institutions – capital, liquidity, risk management, and governance – are risk-based and focused on the desired regulatory behaviors and outcomes mandated by these reforms. Therefore, the Roundtable opposes drawing any bright line around an artificially determined class of institutions because of their size or business lines – which will vary constantly over time - especially since doing so will only increase moral hazard, have a destabilizing effect on competition and the pricing of products, services, and funding, and ultimately work to the disadvantage of the long-term competiveness of U.S. financial services firms and markets.

Consequently, the Roundtable also opposes any forced or unnecessary divestitures of ongoing businesses, especially during an anemic economic recovery. We support stronger capital and liquidity requirements as well as better risk management and supervision – including better consolidated supervision at the parent company level - based on underlying risk fundamentals, but we oppose the artificial and public designation of institutions as systemically important (Tier 1 FHCs) and therefore assumed by the public, potentially, as still "too big to fail," for the reasons noted above. No financial institution should be too big to fail, and, as an aside, the Roundtable fully supports a new orderly resolution process for nonbank financial institutions during times of economic emergencies. In other normal times, bankruptcy should be the preferred option for orderly resolution of failing nonbank financial firms, and it should be harmonized across the financial services industry over time.

2. THE NEED FOR CLEAR OBJECTIVES AND GUIDING PRINCIPLES

The starting for any regulatory reform effort should be common agreement on a few clear objectives for our financial system's role on the real economy – what we want to achieve – and then a companion set of some basic principles for both regulators and regulated firms - to guide how they achieve those objectives. The Administration has outlined five objectives for financial regulatory reform, which at their highest level are hard to oppose and in fact the Roundtable supports as well. We also would encourage the Congress to write into law a set of even higher objectives for our financial markets and their connection to serving consumers and the broader U.S. economy. The Roundtable's three simple objectives, to serve as a discussion starter in this evolving debate, are:

1. Enhance the competitiveness of financial services firms to meet the financial and related needs of all consumers;
2. Promote financial market stability and security; and

3. Support sustained economic growth and new job creation in a globally integrated economy.

If we can agree on some basic objectives about "what" we want our financial system to achieve for the benefit of society, then we need to agree on a set of principles that everyone can understand – regulators, regulated firms, and consumers – about "how" we will achieve those objectives. Guiding principles don't replace the need for more detailed rules especially at the retail level – it's not an either-or discussion - but they do inform desired behavior and outcomes, and they can act as a much needed compass for every stakeholder in our financial markets. Again, the Roundtable believes that Congress should develop a clear set of guiding principles in any reform legislation. To begin this aspect of the debate, our regulatory reform principles for Congress' consideration are:

1. New Architecture. *Our financial regulatory system should be better aligned with modern market conditions and developing global standards.*
2. Consumer and Investor Protection Standards. *Financial services firms engaged in offering comparable products and services should be subject to comparable prudential, consumer, and investor protection standards. In the event of multiple oversight authorities, uniform standards should apply nationwide. Consumer protection should be part of prudential supervision.*
3. Balanced and Effective Regulation. *Financial regulation should be focused on outcomes, not inputs, and should seek a balance between the stability and integrity of financial services firms and markets, consumer protection, innovation, and global competitiveness.*
4. International Cooperation and National Treatment. *U.S. financial regulators should coordinate and harmonize regulatory and supervisory policies with international financial regulatory authorities, and should continue to treat financial services firms doing business in the United States as they treat U.S. financial services firms. The United States should continue to play a leadership role in the current G-20 process to develop new international norms for financial regulation across markets.*
5. Failure Resolution. *Financial regulation should provide for the orderly resolution of failing financial services firms to minimize systemic risk.*
6. Accounting Standards. *U.S. financial regulators should adjust current accounting standards to account for the pro-cyclical effects of the use of fair value accounting in an illiquid market. Additionally, U.S. and International financial regulators should coordinate and harmonize regulatory policies to develop accounting standards that achieve the goals of transparency, understandability and comparability.*

3. THE NEED FOR BOLD, COMPREHENSIVE REGULATORY REFORM

The latest financial crisis has shown us that the time is now for bold, comprehensive regulatory reform. The Roundtable has developed a proposed "Financial Regulatory Architecture" to address the flaws in our current system. Our proposed architecture is designed to:

- Create a better, more rational financial regulatory architecture to support the U.S. economy and meet all consumer financial needs;
- Limit and mitigate systemic risk;
- Reduce regulatory overlap and close critical gaps in regulation;
- Provide for greater coordination among all financial regulators;

- Promote uniform regulation and supervision; and
- Preserve state financial regulation.

Our proposed regulatory architecture can be found on our website at www.fsround.org.

Briefly, the six components of this proposed architecture are as follows. First, to enhance coordination and cooperation among the many and various financial regulatory agencies, we propose to expand membership of the President's Working Group on Financial Markets (PWG) and rename it as the Financial Markets Coordinating Council (FMCC). This Council should be established by law, in contrast to the existing PWG, which has operated under a Presidential Executive Order dating back to 1988. This would permit Congress to oversee its Council's activities. The Council should include representatives from all major federal financial agencies, as well as individuals who can represent state banking, insurance and securities regulation. The Council should serve as a forum for national and state financial regulators to meet and discuss regulatory and supervisory policies, share information, and develop early warning detections. The Council should not have independent regulatory or supervisory powers. However, it might be appropriate for the Council to have some ability to review the goals and objectives of the regulations and policies of federal and state financial agencies, and thereby ensure that they are consistent.

Second, to address systemic risk, we propose that the Federal Reserve Board (Board) should be authorized to act as a market stability oversight authority. If granted this new authority, the Board should be responsible for looking across the entire financial services sector to identify activities, practices, and interconnections that could pose a material systemic risk to the U.S. economy. The interaction of these two points is addressed in the last section of this statement.

Third, to reduce gaps in regulation, we propose the consolidation of several existing federal agencies into a single, National Financial Institutions Regulator (NFIR). This new agency would be a consolidated prudential and consumer protection agency for banking, securities and insurance. The NFIR would reduce regulatory gaps by establishing comparable prudential standards for all of these of nationally chartered or licensed entities. For example, national banks, federal thrifts and federally licensed brokers/dealers that are engaged in comparable activities should be subject to comparable capital and liquidity standards. Similarly, all federally chartered insurers would be subject to the same prudential and market conduct standards.

In the area of mortgage origination, the NFIR's prudential and consumer protection standards should apply to both national and state lenders. Mortgage lenders, regardless of how they are organized, should be required to retain some of the risk for the loans they originate. Likewise, mortgage borrowers, regardless of where they live or who their lender is, should be protected by the same safety and soundness and consumer standards.

Fourth, to focus greater attention on the stability and integrity of financial markets, we propose the creation of a National Capital Markets Agency (NCMA) through the merger of the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC), preserving the best features of each agency. The NCMA would regulate and supervise capital markets and exchanges. As noted above, the existing regulatory and supervisory authority of the SEC and CFTC over firms and individuals that serve as intermediaries between markets and customers, such as broker/dealers, investment companies, investment advisors, and futures commission merchants, and other intermediaries would be transferred to the NFIR. The NCMA also should be responsible for establishing standards for accounting, corporate finance, and corporate governance for all public companies.

Fifth, to protect depositors, policyholders, and investors, we propose that the Federal Deposit Insurance Corporation (FDIC) would be renamed the National Insurance and Resolution Authority (NIRA), and that this agency act not only as an insurer of bank deposits, but also as the guarantor of retail insurance policies written by nationally chartered insurance companies, and a financial backstop for investors who have claims against broker/dealers. These three insurance systems would be legally and functionally separated. The failure of Lehman Brothers illustrated the need for such a better system to address the failure of large non-banking firms.

Finally, to supervise the Federal Home Loan Banks and to oversee the emergence and future restructuring of Fannie Mae and Freddie Mac from conservatorship we propose that the Federal Housing Finance Agency remain in place, pending a thorough review of the role and structure of the housing GSEs in our economy.

Conclusion

The Roundtable believes that the reforms to our financial regulatory system we have proposed would substantially improve the protection of consumers by reducing existing gaps in regulation, enhancing coordination and cooperation among regulators, ensuring greater regulatory accountability for commonly desired regulatory outcomes, and identifying systemic risks. Broader regulatory reform is important not only to ensure that financial institutions continue to meet the needs of all consumers but to restart economic growth and much needed job creation. We support the thrust of the Administration's proposals for a new Council and designating the Federal Reserve as a new market stability oversight authority with the caveats noted above.

Financial reform and ending the recession soon are inextricably linked – we need both. We need a financial system that provides market stability and integrity, yet encourages innovation and competition to serve consumers and meet the needs of a vibrant and growing economy. We need better, more effective regulation and a modern financial regulatory system that is unrivaled anywhere in the world. We deserve no less. The Roundtable stands ready to work closely with the Congress and the Administration to achieve our common goals to help all consumers of financial services and provide a stronger financial market foundation for our economy.