Statement of
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Chairman Frank, Ranking Member Bachus and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding proposed changes under consideration that would improve our financial regulatory system and prevent a recurrence of the costly events of the past year. We need to create a system of macro-prudential supervision and a credible resolution mechanism for systemically important financial firms to address the fundamental causes of the current crisis.

First and foremost, we must find ways to impose greater market discipline on systemically important institutions. Unfortunately, the actions taken during the past year have proven that some financial organizations are too big to fail under our current regulatory regime. This notion creates a vicious circle that needs to be broken.

The financial crisis has taught us that many financial organizations have grown to such size and complexity that, should one of them fail, it could pose systemic risk to the broader financial system. The managers, directors and supervisors of these firms ultimately placed too much reliance on risk management systems that proved flawed in their operations and assumptions. Meanwhile, the markets have funded these organizations at rates that implied they were simply too big to fail. In addition, the difficulty in supervising these firms was compounded by the lack of an effective mechanism to resolve them without damaging the broader financial system.

In a properly functioning market economy there will be winners and losers, and some firms will fail. Actions that prevent firms from failing ultimately distort market mechanisms, including the market's incentive to monitor the actions of similarly situated firms. The most important challenge now is to find ways to impose greater market discipline on systemically important financial organizations.

We have also learned from this financial crisis that market discipline must be more than a philosophy to ward off appropriate regulation during good times. It must be enforced during difficult times. Given this, we need to develop a resolution regime that provides for the orderly wind-down of large, systemically important financial firms, without imposing cost to the taxpayers. In contrast to the current situation, this new regime

should not focus on propping up the current firm and its management. Instead, the resolution regime should concentrate on maintaining the liquidity and key activities of the organization so that the entity can be resolved in an orderly fashion without disrupting the functioning of the financial system. Losses should be borne by the stockholders and bondholders of the holding company, and senior management should be replaced. Without a new comprehensive resolution regime, we will be forced to repeat the costly, ad hoc responses of the last year.

My testimony addresses the urgent need to create a credible resolution regime that can effectively address failed financial firms regardless of their size or complexity and assure that shareholders and creditors absorb losses without cost to the taxpayer. This mechanism is at the heart of a sustainable solution -- a comprehensive resolution facility that will impose losses on shareholders and unsecured debt investors, while maintaining financial market stability and minimizing systemic consequences for the national and international economy. The credibility of this resolution mechanism would be further enhanced by requiring each financial holding company with subsidiaries engaged in non-banking financial activities to have, under rules established by the FDIC, a resolution plan that would be annually updated and published for the benefit of market participants and other customers. Under this requirement, large financial organizations would have to demonstrate that they could be effectively broken up into their functional components and liquidated in an orderly way.

In addition, my testimony discusses the FDIC's perspective on improving the supervision of systemically important institutions and the early identification and remediation of issues that pose risks to the financial system. The new structure should address such issues as the industry's excessive leverage, inadequate capital and over-reliance on short-term funding. In addition, the regulatory structure should ensure real corporate separateness and the separation of the insured bank's management, employees and systems of its affiliates. Risky activities, such as proprietary and hedge fund trading, should be kept outside of insured banks and subject to enhanced capital requirements.

The combined enhanced supervision and unequivocal prospect of an orderly resolution will go a long way to assuring that the problems of the last several years are not repeated and that any problems that do arise can be handled without cost to the taxpayer.

The Need for Improved Resolution Authority

The current crisis has clearly demonstrated the need for a single resolution mechanism for failing financial firms that will restore market discipline by imposing losses on shareholders and creditors and replacing senior management. A timely, orderly resolution process that could be applied to both banks and non-bank financial institutions, and their holding companies, would prevent instability and contagion and promote fairness. It would enable the financial markets to continue to function smoothly, while providing for an orderly transfer or unwinding of the firm's operations. The

resolution process would ensure that there is the necessary liquidity to complete transactions that are in process at the time of failure, thus addressing the potential for systemic risk without creating the expectation of a bailout.

Under the new resolution regime, Congress should raise the bar higher than existing law and eliminate the possibility of open assistance for individual failing entities. The new resolution powers should result in the shareholders and unsecured creditors taking losses. Consideration also should be given to imposing some haircut on secured creditors to promote market discipline, limit costs to the receivership, and distribute market losses more broadly. The priority protection given to secured creditors under both the bankruptcy code as well as the FDIC's resolution mechanism creates incentives to rely excessively on short term, secured financing. Too many creditors have looked to the value of their collateral -- as opposed to the credit worthiness of their counterparties -- in making credit decisions.

Limitations of the current resolution authority

The FDIC's resolution powers are very effective for most failed bank situations. However, systemic financial organizations present additional issues that may complicate the FDIC's process of conducting an efficient and economical resolution. As noted above, many financial activities today take place in financial firms that are outside the insured depository institution and beyond the FDIC's existing authority. These financial firms must be resolved through the bankruptcy process, as the FDIC's resolution powers only apply to insured depository institutions. Resolving large complex financial firms through the bankruptcy process can be destabilizing to regional, national and international economies since there is no protection for the public interest, and the process can be complex and protracted and may vary by jurisdiction.

By contrast, the powers that are available to the FDIC under its statutory resolution authorities can resolve financial entities much more rapidly than under bankruptcy. The FDIC bears the unique responsibility for resolving failed depository institutions and is therefore able to plan for an orderly resolution process. Through this process, the FDIC works with the primary supervisor to gather information on a troubled bank before it fails and plans for the transfer or orderly wind-down of the bank's assets and businesses. Importantly, the FDIC has the authority to create bridge institutions to maintain the bank's franchise value and critical operations pending their sale. In doing so, the FDIC is able to maintain public confidence and perform its public policy mandate of ensuring financial stability.

R**esolution authority for systemically important financial firms**

Financial firms often operate on a day-to-day basis with little regard to the legal structure of their affiliates. That is, employees of the holding company may provide vital services to a subsidiary bank because the same function exists in both the bank and the holding company. One affiliate may provide IT services to other parts of the organization. Loan servicing and asset management may also be provided by one

affiliate to the insured bank and other subsidiaries. Foreign deposits may fund domestic loans. Some complex derivatives positions are comprised of transactions booked by investment banking affiliates and other transactions booked in the insured bank. This intertwining of functions can present significant issues when trying to wind down the firm. For this reason, there should be requirements that mandate greater functional autonomy of holding company affiliates.

In addition, to facilitate the resolution process, the holding companies should have an acceptable resolution plan that could facilitate and guide the resolution in the event of a failure. Through a carefully considered rulemaking, each financial holding company should be required to make conforming changes to their organization to ensure that the resolution plans could be effectively implemented. The plans should be updated annually and made publicly available.

Congress should also prohibit open company assistance that benefits the shareholders and creditors of individual institutions. This ban should apply to any assistance provided by the government including lending programs provided by the Federal Reserve Board under Section 13(3) of the Federal Reserve Act. The government should not be in the position of picking winners and losers among poorly managed firms that can no longer function without government assistance. Those institutions should be placed into receivership, and their shareholders and creditors, not the government, should be required to absorb losses from the institution's failure.

This means that Congress should do away with the provision in current law that allows for an exception to the standard claims priority where the failure of one or more institutions presents "systemic risk." In other words, once a systemic risk determination is made, the law permits the government to provide assistance irrespective of the least cost requirement, including "open bank" assistance which inures to the benefit of shareholders. The systemic risk exception is an extraordinary procedure, requiring the approval of super-majorities of the FDIC Board, the Federal Reserve Board, and the Secretary of the Treasury in consultation with the President.

We believe that the only time a systemic risk exception should made available is when there is a finding that the entire system is at risk and that even healthy institutions cannot obtain access to liquidity. Whatever support is provided should be broadly available and justified in that it will result in least cost to the government as a whole. If the government suffers a loss as a result of an institution's performance under this exception, the institution should be placed into receivership and resolved in accordance with the standard claims priority.

The initiation of this type of systemic assistance should require the same concurrence of the super-majority of the FDIC Board, the Federal Reserve Board and the Treasury Department (in consultation with the President) as under current law. This should be true, whether it is the FDIC or any other governmental entity providing the assistance, including that provided by the Federal Reserve Board through its Section 13(3) authority. In addition, we believe that additional requirements are appropriate for this

type of systemic assistance, such as advance consultation with the Congressional leadership and a subsequent audit by the GAO. The risk of moral hazard from such programs is just as acute, whether the assistance is coming from the FDIC or another governmental entity and thus the triggering mechanism should set a very high bar.

Funding Systemic Resolutions

To be credible, a resolution process for systemically significant institutions must have the funds necessary to accomplish the resolution. It is important that funding for this resolution process be provided by the set of potentially systemically significant financial firms, rather than by the taxpayer. To that end, Congress should establish a Financial Company Resolution Fund (FCRF) that is pre-funded by levies on larger financial firms -- those with assets of at least $10 billion. The systemic resolution entity should have the authorities needed to manage this resolution fund, as the FDIC does for the Deposit Insurance Fund (DIF). The entity should also be authorized to borrow from the Treasury and those borrowings should be repaid by the financial firms that contribute to the FCRF. We believe that a pre-funded FCRF has significant advantages over an ex post funded system. It allows all large firms to pay risk-based assessments into the FCRF, not just the survivors after any resolution, and it avoids the pro-cyclical nature of requiring repayment after a systemic crisis.

Resolution Authority for Depository Institution Holding Companies

To have a process that not only maintains liquidity in the financial system but also terminates stockholders' rights, it is important that the FDIC have the authority to resolve both systemically important and non-systemically important depository institution holding companies, affiliates and majority-owned subsidiaries in the case of failed or failing insured depository institutions. When a failing bank is part of a large, complex holding company, many of the services essential for the bank's operation may reside in other portions of the holding company, beyond the FDIC's authority. The loss of essential services can make it difficult to preserve the value of a failed institution's assets, operate the bank or resolve it efficiently. The business operations of large, systemic financial organizations are intertwined with business lines that may span several legal entities. When one entity is in the FDIC's control while the other is not, it significantly complicates resolution efforts. Unifying the holding company and the failed institution under the same resolution authority can preserve value, reduce costs and provide stability through an effective resolution. Congress should enhance the authority of the FDIC to resolve the entire organization in order to achieve a more orderly and comprehensive resolution consistent with the least cost to the DIF, after consultation with the holding company's primary regulator.

When the holding company structure is less complex, the FDIC may be able to effect a least cost resolution without taking over the holding company. In cases where the holding company is not critical to the operations of the bank or thrift, the FDIC should be able to opt out -- that is, allow the holding company to be resolved through the bankruptcy process. The decision on whether to employ enhanced resolution powers or

allow the bank holding company to declare bankruptcy would depend on which strategy would result in the least cost to the DIF. Enhanced authorities that allow the FDIC to efficiently resolve failed depository institutions that are part of a complex holding company structure when it achieves the least costly resolution will provide immediate efficiencies in bank resolutions.

The Need for Improved Supervision and Regulation

The unprecedented size and complexity of many of today's financial institutions raise serious issues regarding whether they can be properly managed and effectively supervised through existing mechanisms and techniques. Our current system clearly failed in many instances to manage risk properly and to provide stability. Many of the systemically significant entities that have needed federal assistance were already subject to extensive federal supervision. For various reasons, these powers were not used effectively and, as a consequence, supervision was not sufficiently proactive.

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 non-bank 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.

A strong case can be made for creating incentives that reduce the size and complexity of financial institutions. Financial firms that pose systemic risks should be subject to regulatory and economic incentives that require these institutions to hold larger capital and liquidity buffers to mirror the heightened risk they pose to the financial system. In addition, restrictions on leverage and the imposition of risk-based premiums on institutions and their activities would act as disincentives to growth and complexity that raise systemic concerns. In contrast to the standards implied in the Basel II Accord, systemically important firms should face additional capital charges based on both their size and complexity. To address pro-cyclicality, the capital standards should provide for higher capital buffers that increase during expansions and are available to be drawn down during contractions. In addition, these firms should be subject to higher Prompt Corrective Action standards under U.S. laws and holding company capital requirements that are no less stringent than those applicable to insured banks. Regulators also should take into account off-balance-sheet assets and conduits as if these risks were on-balance-sheet.

The Need for a Financial Services Oversight Council

The significant size and growth of unsupervised financial activities outside the traditional banking system -- in what is termed the shadow financial system -- has made it all the more difficult for regulators or market participants to understand the real dynamics of either bank credit markets or public capital markets. The existence of one regulatory framework for insured institutions and a much less stringent prudential regulatory scheme for non-bank entities created the conditions for arbitrage that permitted the development of risky and harmful products and services outside regulated entities.

A distinction should be drawn between the direct supervision of systemically-significant financial firms and the macro-prudential oversight and regulation of developing risks that may pose systemic risks to the U.S. financial system. The former appropriately calls for the identification of a prudential supervisor for any firm that raises potential systemic risks. Entities that are already subject to a prudential supervisor, such as insured depository institutions and financial holding companies, should retain those supervisory relationships.

The macro-prudential oversight of system-wide 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. As a result, for this latter role, the FDIC supports the creation of a Council to oversee systemic risk issues, develop needed prudential policies and mitigate developing systemic risks. In addition, for systemic entities not already subject to a federal prudential supervisor, this Council should be empowered to require that they submit to such oversight, presumably as a financial holding company under the Federal Reserve -- without subjecting them to the activities restrictions applicable to these companies.

Supervisors across the financial system failed to identify the systemic nature of the risks before they were realized as widespread industry losses. The performance of the regulatory system in the current crisis underscores the weakness of monitoring systemic risk through the lens of individual financial institutions and argues for the need to assess emerging risks using a system-wide perspective. The current proposal addresses the need for broader-based identification of systemic risks across the economy and improved interagency cooperation through the establishment of a new Financial Services Oversight Council. The Oversight Council described in the proposal currently lacks sufficient authority to effectively address systemic risks.

In designing the role of the Council, it will be important to preserve the longstanding principle that bank regulation and supervision are best conducted by independent agencies. Careful attention should be given to the establishment of appropriate safeguards to preserve the independence of financial regulation from political influence. To ensure the independence and authority of the Council, consideration should be given to a configuration that would establish the Chairman of the Council as a Presidential

appointee, subject to Senate confirmation. This would provide additional independence for the Chairman and enable the Chairman to focus full time on attending to the affairs of the Council and supervising Council staff. Other members on the Council could include, among others, the federal financial institution, securities and commodities regulators. In addition, we would suggest that the Council include an odd number of members in order to avoid deadlocks.

The Council should complement existing regulatory authorities by bringing a macro-prudential perspective to regulation and being able to set or harmonize prudential standards to address systemic risk. Drawing on the expertise of the federal regulators, the Oversight Council should have broad authority and responsibility for identifying institutions, products, practices, services and markets that create potential systemic risks, implementing actions to address those risks, ensuring effective information flow, and completing analyses and making recommendations. In order to do its job, the Council needs the authority to obtain any information requested from systemically important entities.

The crisis has clearly revealed that regulatory gaps, or significant differences in regulation across financial services firms, can encourage regulatory arbitrage. Accordingly, 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 that apply to commercial banks, investment banks, and investment funds to determine the extent to which different standards circumvent regulatory efforts to contain excess leverage in the system. The Council could also undertake the harmonization of capital and margin requirements applicable to all over the counter (OTC) derivatives activities, and assure that differences in the treatment of OTC derivatives and exchange traded derivatives do not create dis-incentives for derivatives to be centrally traded on exchanges or through CCPs. This would facilitate interagency efforts to encourage greater use of standardized, centrally traded derivatives.

The Council's rulemaking authority should serve as a floor that must be met and could be exceeded, as appropriate, by the primary prudential regulator. Primary regulators would be charged with enforcing the requirements set by the Council. However, if the primary regulators fail to act, the Council should have the authority to do so. The standards set by the Council should be designed to provide incentives to reduce or eliminate potential systemic risks created by the size or complexity of individual entities, concentrations of risk or market practices, and other interconnections between entities and markets. Any standards set by the Council should be construed as a minimum floor for regulation that can be exceeded, as appropriate, by the primary prudential regulator.

The Council should have the authority to consult with systemic and financial regulators from other countries in developing reporting requirements and in identifying potential systemic risk in the global financial market. The Council also should report to Congress

annually about its efforts, identify emerging systemic risk issues and recommend any legislative authority needed to mitigate systemic risk.

Some have suggested that a council approach would be less effective than having this authority vested in a single agency because of the perception that a deliberative council such as this would need additional time to address emergency situations that might arise from time to time. Certainly, some additional thought and effort will be needed to address any dissenting views in council deliberations. However, a Council with regulatory agency participation will provide for an appropriate system of checks and balances to ensure that decisions reflect the various interests of public and private stakeholders. In this regard, it should be noted that the board structure at the FDIC, with the participation of the Comptroller of the Currency and the Director of the Office of Thrift Supervision, is not very different from the way the Council would operate. In the case of the FDIC, quick decisions have been made with respect to systemic issues and emergency bank resolutions on many occasions. Based on our experience with a board structure, we believe that decisions could be made quickly by a deliberative council.

Conclusion

The current financial crisis demonstrates the need for changes in the supervision and resolution of financial companies, especially those that are systemically important to the financial system. The FDIC stands ready to work with Congress to ensure that the appropriate steps are taken to strengthen our supervision and regulation of all financial companies -- especially those that pose a systemic risk to the financial system.

I would be pleased to answer any questions from the Committee.

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