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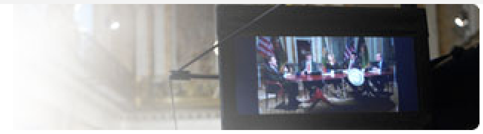

Treasury Secretary Timothy F. Geithner Written Testimony House Financial Services Committee Financial Regulatory Reform

9/23/2009

Chairman Frank, Ranking Member Bachus, members of the House Financial Services Committee, I am pleased to be back before you today as our Administration and this Congress work toward comprehensive reform of our financial regulatory system.

The Chairman has set an ambitious schedule of hearings that will lead to your markup of legislation and facilitate enactment this year. We have now provided more than 600 pages of legislative language, and I am aware and appreciative of the long hours you have spent working through the critical details of reform. My staff has been in constant contact with members of this committee and with your staff, and will continue to be as we work through key issues.

As you prepare to put this legislation together and we prepare to help, it might be useful to remind ourselves why we have a financial system in the first place and why we have reached this moment of decision.

Stripped of its complexities, the purpose of a financial system is to let those who want to save--whether for vacation, retirement or a rainy day--save. It is to let those who want to borrow--whether to buy a house or build a business--borrow. And it is to use our banks and other financial institutions to bring savers' funds and borrowers' needs together and carefully manage the risks involved in transfers between them.

The job of a financial system, in other words, is to efficiently allocate savings and risk.

Last fall, our financial system failed to do its job, and came precariously close to failing altogether.

In September alone, Fannie Mae and Freddie Mac were put into government conservatorship. Lehman Brothers collapsed. Merrill Lynch, Wachovia and Washington Mutual were acquired in distress. A $62 billion dollar money market fund "broke the buck." The world's largest insurer avoided bankruptcy only with the help of $85 billion in emergency aid. Goldman Sachs and Morgan Stanley announced they would protect themselves by becoming bank holding companies. When Congress' first attempt to pass the Emergency Economic Stabilization Act (EESA) failed, the stock market took a historic plunge.

In a matter of just three months, five trillion dollars of Americans' household wealth evaporated. Economic activity and trade around the world ground toward a halt.

The failure was so sudden and far-reaching that the government was forced to step in to restore the flow of funds between savers and borrowers. Congress courageously passed EESA. Upon taking office, President Obama moved quickly on all fronts, working with Congress to win approval for a recovery act to help the economy and launching a stability plan to help repair the financial system and restart lending.

A year has passed since the crisis peaked. There is little doubt that we have moved back from the financial brink and toward economic recovery. Important parts of the financial system are back to functioning on their own. Some of the damage to people's savings has been repaired. We have taken the first steps towards reducing the government's direct involvement in the system and the risks that taxpayers are bearing.

But make no mistake: The flaws in our financial system and regulatory framework that allowed this crisis to occur, and in many ways helped cause it, are still in place. We may disagree over details of how to best fix those flaws, but that cannot mean we do not act.

We simply cannot walk away from the worst financial crisis since the Great Depression and not do everything in our power to reform the system that contributed to this breakdown.

At a minimum, reform must achieve these critical objectives:

- It must provide substantial new protections for consumers and investors.
- It must create a more stable, safer financial system, one less prone to crisis.
- And it must safeguard American taxpayers from having to bear the costs of battling future crises.

To achieve these objectives will require changes across the entire financial system. Let me lay out some of the changes, and briefly explain how the Administration reform plan will make them.

Reform requires a fundamental overhaul of consumer and investor protections so that Americans are told about the risks of financial products and services in ways they can understand, and providers live by commonsense rules in delivering those products and services.

The Administration proposal will effect this overhaul. It will strengthen standards for investment advisors and brokers while expanding Securities and Exchange Commission (SEC) authority over disclosure and enforcement. And for the first time, it will provide consumers with a dedicated agency to set and enforce clear rules for both banks and non-banks in credit cards, mortgages and savings accounts.

Reform requires comprehensive oversight of the financial system to eliminate dangerous gaps and loopholes.

Our proposal is comprehensive. It will address the core regulatory failures and weaknesses that directly contributed to the crisis, and the dangers that could lead to the next one.

It will close gaps and loopholes that encouraged games-playing and enabled firms to evade strong government oversight. It will do so by, among other things, merging the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) into a new National Bank Supervisor.

It will eliminate competing regimes for holding company supervision and correct inconsistencies that allow firms to own banks, but still avoid supervision and regulation as bank holding companies. It will bring unregulated firms and markets into the system by requiring registration of hedge funds, and setting clear rules for all derivatives markets. Perhaps most importantly, it will require regulators to take the broad view – regulating firms and markets with an eye to the safety of the entire financial system, and not just that of individual institutions.

Reform requires tighter constraints on leverage so that institutions arrive at the eve of future periods of financial stress less indebted and better able to bear their own risks.

Our proposal will tighten constraints by requiring that all financial firms hold higher capital and liquidity buffers. It will establish a higher baseline for all firms, and then go beyond that baseline to impose still higher standards on the largest, most leveraged and most interconnected firms that pose the greatest risk to the system as a whole.

To protect the system in moments of crisis, reform requires better preparation and better tools to respond. Our proposal will require the largest, most interconnected firms to prepare plans for how they should be dismantled in case of failure, and will provide for the orderly unwinding of these firms in a way that protects taxpayers and the broader economy while ensuring that losses are borne by creditors and other stakeholders.

Finally, reform requires that as we in the United States strengthen our system, other nations take similar steps to strengthen their own systems, protect against cross-border gamesmanship, and ensure that the global financial system is safer and more stable. I will accompany President Obama to Pittsburgh later this week to advance the work that we have already done in this regard with our G-20 partners.

Today, I want to focus on two key challenges that are at the center of the debate over regulatory reform. The first is how to strike the right balance between protecting the stability of the system and American families' finances while still fostering innovation, growth and prosperity. The second is how to address the challenge of firms whose failure, absent reform, could threaten the stability of the financial system – the challenge of so-called "too big to fail" firms.

Concerns have been raised about whether, in seeking to restore stability and fairness to our financial system, our plan will impose excessive burdens on the financial industry or stifle critically important innovation. These questions have been raised especially in connection with our consumer protection proposal.

The need for a dedicated, consolidated consumer protection agency is clear. The current consumer protection system failed to protect consumers, responsible providers, or market efficiency and innovation.

It failed to protect consumers from unexpected risks. Instead, it led them into a housing and consumer debt crisis.

It failed to maintain a level playing field for responsible providers; instead, it let a large unregulated sector drag down standards.

And it failed to set clear rules of the road for sustainable innovation to thrive. Instead, it left a vacuum in which institutions, including many subject to extensive federal oversight, followed their competitors down the easy path of tricks and traps for short-term gain.

These failures were structural. That is because there is no home in today's regulatory system for the mission of protecting consumers and providing the market clear rules for sustainable innovation. There is no authority in federal regulations for watching over the parts of the consumer market that are operated by non-bank institutions. And the authority for watching over banks in that market is so fragmented among regulators that it encourages them to drag feet and point fingers instead of acting, and invites corrosive competition in regulatory laxity.

Consumer protection cannot be reformed without addressing these structural problems. Our proposal will address them directly. It will consolidate fragmented consumer authorities into one agency, the Consumer Financial Protection Agency (CFPA), which will write rules, oversee compliance, and address violations by non-bank providers, as well as banking institutions.

Effective protection requires consolidated authority to both write rules and conduct oversight and enforcement.

Combining these authorities will ensure that the agency has a wide range of tools to address any problem within its domain, and can choose those that are most effective and impose the least burden.

Rule-writing authority without supervisory authority – including reporting and examinations – and enforcement authority would risk creating an agency that is weak and ill-informed, and dominated by agencies with enforcement authority. If enforcement and supervisory authorities remain divided among the agencies as they are today, we will continue to see regulatory inertia and arbitrage, uneven protection, and eroding standards. Just as importantly, a rule-writing agency that does not receive information from and examine institutions and address their violations will not understand how institutions operate and the burdens that regulations put on them. Such an agency will likely underestimate the costs of regulation and fail to get the balance between costs and benefits right.

Our proposal will not create new bureaucracy for banks. It will take consumer authorities spread across many agencies and combine them in one place.

Our proposal will not increase the regulatory burdens on community banks. Most community banks do not pay assessments for federal supervision today, and our plan will preserve that arrangement. Examination schedules will be coordinated between agencies, which will exchange examination reports to promote consistency. Clear delineation of agencies' roles will keep conflicts to a minimum, and the rare conflict will be resolved with a reasonable dispute resolution mechanism. In the case of mortgages, institutions making them will see a cost savings when the agency integrates federal mortgage disclosures now implemented separately by two different regulators.

The CFPA will save firms from having to face a choice between losing revenues or stooping to the questionable practices of less-responsible competitors. This will be of particular benefit to community and regional banks that lost revenues when they refused to compete on terms set by unregulated mortgage lenders and brokers. These banks' competitors in the non-bank sector will face federal oversight for the first time.

Moreover, the CFPA will allocate its oversight resources on the basis of risk to consumers. Firms that pose less risk to consumers will face proportionally less burdensome oversight. Risk-based oversight will help banks that have the strongest incentives to treat their customers fairly because they serve a relatively fixed customer base in a limited geographic area and have deep ties to their communities. These are most frequently community banks.

Our proposal will also meet the challenge of preserving innovation. It will do so by giving the agency a focused and balanced mission to protect consumers from abuse while simultaneously ensuring that markets are efficient and that innovation can thrive.

Innovation is essential to the growth of our financial system and the prosperity of our country. We especially value innovation in consumer financial products because it better matches products to consumer preferences. But without clear rules, firms can innovate in ways that erode standards and threaten stability.

Without adequate regulation, American families were enticed to switch credit cards with balance transfer offers at low interest rates of which they could not take advantage if they put gas and groceries on the card. They got mortgages with interest rates that shot up painfully in two years or sometimes less, and which often had increasing loan balances. They got hidden late fees, penalty rates, and prepayment penalties. These risks were disclosed, if at all, in fine print that no reasonable consumer could be expected to see and understand.

When developments such as these were introduced, they were frequently hailed as innovations. And in fact, features that can harm some consumers but provide more benefit to others have a place in a well-functioning market. We firmly believe that consumers should have the ability to choose those offerings that they believe best meet their needs if they can make well-informed choices.

Consumers can not be assured the opportunity to make informed choices about the risks without clear rules of the road. Innovation without regulation leads to a race to the bottom based on exploiting consumer confusion. Without rules, the firm that makes its product appear more attractive by hiding the real cost to the consumer wins. Perhaps a firm does not want to take that route, but competition forces it to. Without a strong framework of regulation, banks and other providers compete to take advantage of consumer confusion rather than to better serve consumer preferences. This must end.

Let me turn to the challenge of "too big to fail" firms.

The sudden collapses of Bear Stearns, Lehman Brothers, and AIG demonstrated that our framework for supervision and regulation of large, highly leveraged and substantially interconnected financial firms – and the government's toolkit for managing their failure – is profoundly inadequate.

There were many causes for the growth of these large, leveraged, and interconnected financial firms over the past few decades, but important among them was the assumption on the part of investors and others that these firms would receive government assistance if they ran into trouble.

The assumption undermined market discipline and contributed to excessive risk-taking by the firms. And the actions of the federal government over the past 18 months to support our major financial firms, while necessary to prevent an implosion of our financial system and deeper damage to our economy, have solidified the market perception that Washington will always be there to help these firms.

Addressing the threats to financial stability posed by large, leveraged, and interconnected financial firms is central to the Administration's financial regulatory reforms. Here is how our plan will accomplish this goal.

First, we cannot allow firms to reap the benefits of explicit or implicit government subsidies without very strong government oversight. We must substantially reduce the moral hazard created by the perception that these subsidies exist; address their corrosive effects on market discipline; and minimize their encouragement of risk-taking. So, for example, we cannot permit weak regulation of government-sponsored enterprises like Fannie Mae and Freddie Mac that accumulate trillions of dollars of exposure that is implicitly backed by the taxpayer. We cannot again permit our largest investment banks or other firms to operate without real consolidated supervision, yet obtain government assistance when they collapse.

We will provide the federal government with the authority and responsibility to oversee every financial firm that poses a threat to financial stability. Most of these firms already are organized as bank holding companies and therefore already are subject to supervision and regulation by the Federal Reserve. But our current laws do not ensure that the government will have oversight over all major financial firms. Going forward, the government must have the authority to extend a common framework of supervision and regulation over all financial firms that present outsized systemic risks.

Second, we will impose tough rules on our largest, most leveraged, and most interconnected firms. We will require these firms to hold more capital to protect the system in the event of the firm's failure. And we will make the financial markets more resilient.

We will require bigger buffers in the financial system to make it strong enough to withstand the failure of individual firms, and will reduce the threat of contagion caused by interconnections among major firms. This will include raising capital and liquidity requirements for all banking firms, and raising capital charges on exposures between financial firms. It will include comprehensively regulating over-the-counter (OTC) derivative markets, including by substantially increasing the use of well-regulated central clearing platforms. And it will include strengthening supervision and regulation of critical payment, clearing, and settlement systems

We will supervise our major financial firms more intensively and, after the financial system has had time to emerge from the recent crisis, we will hold these firms to tougher safety and soundness standards than other firms, including tougher capital and liquidity requirements. We will require that supervision of these firms include effective oversight of the parent company and all of its subsidiaries. And we will require a new kind of supervision of these firms – one designed to protect overall financial stability and not just the solvency of individual companies.

Our plan for stricter supervision and regulation of the major financial firms will have several powerful effects. It will force these firms to pay an appropriate regulatory price for the risks that their failure or distress could impose on the broader financial system. It will offset the perceived government support enjoyed by these firms, which should substantially reduce any competitive advantage they have due to the market's assumption that they would receive assistance in the event of failure. In sum, our proposals will provide positive incentives for these firms to shrink and to reduce their leverage, complexity, and interconnectedness. In addition, more conservative supervision and regulation of our major financial firms should reduce the probability that they will fail and therefore the likelihood that they will pose a threat to the financial system.

Third, we must reduce moral hazard, improve market discipline, and limit the risk that the taxpayer has to bear in the next crisis and the costs they shoulder. Our plan will do this in a number of ways.

We will require our major financial firms to prepare and regularly update a credible plan for their rapid resolution in the event of severe financial distress. We will require supervisors to carefully evaluate the plan on an ongoing basis. This requirement will create incentives for a firm to better monitor and simplify its organizational structure and would better prepare the government – as well as the firm's investors, creditors, and counterparties – in the event the firm collapsed.

In addition, as Lehman's collapse showed, existing bankruptcy arrangements are often ill-suited for dealing with the insolvency of large financial institutions. We will give the government the capacity, as it has now for banks and thrifts, to dismember or unwind major financial firms in an orderly fashion with less collateral damage to the system. Simultaneously, we will enhance market discipline by enabling the government to manage the resolution of troubled firms in a manner that imposes losses on firms' stakeholders.

It is imperative that we minimize the risks that taxpayers pay the price of a future rescue of the financial sector. Therefore, any losses that might be incurred by the government in its efforts to resolve failing financial firms will be recouped through assessments on other large financial firms.

Crucially under our proposals, there will be no fixed list of Tier 1 FHCs, and identification of a firm as a Tier 1 FHC will not convey a government subsidy – it will be no guarantee of extraordinary governmental assistance in the event of financial distress. To the contrary; it will be a guarantee of substantially stricter supervision and regulation by the government – an intensity of government oversight that will serve as a strong disincentive for firms to become too big, complex, leveraged, and interconnected.

We understand the need to coordinate regulation of major financial firms internationally to prevent geographic regulatory arbitrage. Financial firms, markets, and transactions have never been more globally mobile. The G-20 Leaders have acknowledged that we must raise safety and soundness standards for all major financial firms to consistently high levels, and we look forward to working with our colleagues around the world to do just that.

No private economic system can function effectively if firms are insulated from the full consequences of their bad decisions. History suggests that periods of financial stress will happen again in the future. Therefore, it is critical to limit the systemic footprint of individual firms and to reduce the likelihood of, and the potential damage to the financial system from, the failure of our major financial firms. Accomplishing these goals and reducing the need for government support of financial institutions in the future is a fundamental issue of fairness, and it is essential to making the financial system more stable, efficient, and robust.

Mr. Chairman, in the coming weeks, your Committee and we in the Administration will have to work through difficult details on all of the issues I have discussed today and others as well in order for you to enact the historic legislation that you are now preparing to move. And we appreciate that you have joined the President in committing to enact this legislation by year's end.

But as we do this, we must remember the President's admonition on Wall Street last week. Time is the enemy of reform. As some normalcy returns to our financial system and our economy, we cannot let it be cause for complacency.

We must act to correct the regulatory problems that have left our financial system so fragile and prone to further trouble that Americans come to distrust it as a reliable repository for their savings and a stable source of the credit they need to conduct their lives and build their businesses.

Thank you.

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