Consumer Federation of America

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Mr. Chairman and Members of the Committee, my name is Travis Plunkett. I am Legislative Director of the Consumer Federation of America (CFA). CFA is a non-profit association of 280 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy, and education.

I greatly appreciate the opportunity to appear before you today to testify about one of the most important issues Congress will need to address as it develops a comprehensive agenda to reform our nation's failed financial regulatory system – how to better protect the system as a whole and the broader economy from systemic risks. Recent experience has shown us that our current system was not up to the task, either of identifying significant risks, or of addressing those risks before they spun out of control, or of dealing efficiently and effectively with the situation once it reached crisis proportions. The effects of this failure on the markets and the economy have been devastating, rendering reform efforts aimed at protecting the system against systemic threats a top priority.

In order to design an effective regulatory response, it is necessary to understand why the system failed. It has been repeated so often in recent months that it has taken on the aura of gospel, but it is simply not the case that the systemic risks that have threatened the global financial markets and ushered in the most serious economic crisis since the Great Depression arose because regulators lacked either sufficient information or the tools necessary to protect the financial system as a whole against systemic risks. (Though it is true that, once the crisis struck, regulators lacked the tools needed to deal with it effectively.) On the contrary, the crisis resulted from regulators' refusal to heed overwhelming evidence and repeated warnings about growing threats to the system.

- Former Congressman Jim Leach and former CFTC Chairwoman Brooksley Born both identified the potential for systemic risk in the unregulated over-the-counter derivatives markets in the 1990s.

- Housing advocates have been warning the Federal Reserve since at least the early years of this decade that securitization had fundamentally changed the underwriting standards for mortgage lending, that the subprime mortgages being written in increasing numbers were unsustainable, that foreclosures were on the rise, and that this had the potential to create systemic risks.

- The SEC's risk examination of Bear Stearns had, according to the agency's Inspector General, identified several of the risks in that company's balance sheet, including its use of excessive leverage and an over-concentration in mortgage-backed securities.

Contrary to conventional wisdom, these examples and others like them provide clear and compelling evidence that, in the key areas that contributed to the current crisis – unsound mortgage lending, the explosive combination of risky assets and excessive leverage on financial institutions' balance sheets, and the growth of an unregulated "shadow" banking system – regulators had all the information they needed to identify the crucial risks that threatened our financial system but either didn't use the authority they had or, in Born's case, were denied the authority they needed to rein in those risks.

Regulatory intervention at any of those key points had the potential to prevent, or at least greatly reduce the severity of, the current financial crisis – either by preventing the unsound mortgages from being written that triggered the crisis, or by preventing investment banks and other financial institutions from taking on excessive leverage and loading up their balance sheet with risky assets, leaving them vulnerable to failure when the housing bubble burst, or by preventing complex networks of counterparty risk to develop among financial institutions that allowed the failure of one institution to threaten the failure of the system as a whole. This view is well-articulated in the report of the Congressional Oversight Panel, which correctly identifies a fundamental abandonment of traditional regulatory principles as the root cause of the current financial crisis and prescribes an appropriately comprehensive response.

So what is the lesson to be learned from that experience for Congress's current efforts to enhance systemic risk regulation? The lesson is emphatically not that there is no need to improve systemic risk regulation. On the contrary, this should be among the top priorities for financial regulatory reform. But there is a cautionary lesson here about the limitations inherent in trying to address problems of inadequate systemic risk regulation with a structural solution. In each of the above examples, and others like them, the key problem was not insufficient information or inadequate authority; it was an unwillingness on the part of regulators to use the authority they had to rein in risky practices. That lack of regulatory will had its roots in an irrational faith among members of both political parties in markets' ability to self-correct and industry's ability to self-police.

Until we abandon that failed regulatory philosophy and adopt in its place an approach to regulation that puts its faith in the ability and responsibility of government to serve as a check on industry excesses, whatever we do on systemic risk is likely to have little effect. Without that change in governing philosophy, we will simply end up with systemic risk regulation that exhibits the same unquestioning, market-fundamentalist approach that has characterized substantive financial regulation to a greater or lesser degree for the past three decades.

If the "negative" lesson from recent experience is that structural solutions to systemic risk regulation will have limited utility without a fundamental change in regulatory philosophy, there is also a positive corollary. Simply closing the loopholes in the current regulatory structure, reinvigorating federal regulators, and doing an effective job at the day-to-day tasks of routine safety and soundness and investor and consumer protection regulation would go a long way toward eliminating the greatest threats to the financial system.

The "Shadow" Banking System Represents the Greatest Systemic Threat

In keeping with that notion, the single most significant step Congress could and should take right now to decrease the potential for systemic risk is to shut down the shadow banking system completely and permanently. While important progress is apparently being made (however slowly) in moving credit default swaps onto a clearinghouse, this is just a start, and a meager start at that. Meaningful financial regulatory reform must require that all financial activities be conducted in the light of regulatory oversight according to basic rules of transparency, fair dealing, and accountability.

As Frank Partnoy argued comprehensively and persuasively in his 2003 book, *Infectious Greed,* a primary use of the "shadow" banking system – and indeed the main reason for its existence – is to allow financial institutions to do indirectly what they or their clients would not be permitted to do directly in the regulated markets. So banks used unregulated special purpose entities to hold toxic assets that, if held on their balance sheets, would have required them to set aside additional capital, relying on the fiction that the bank itself was not exposed to the risks. Investment banks sold Mezzanine CDOs to pension funds in private placements free from disclosure and other obligations of the regulated marketplace. And everyone convinced themselves that they were protected from the risks of those toxic assets because they had insured them using credit default swaps sold in the over-the-counter market without the basic protections that trading on an exchange would provide, let alone the reserve or collateral requirements that would, in the regulated insurance market, provide some assurance that any claims would be paid.

The basic justification for allowing two systems to grow up side-by-side – one regulated and one not – is that sophisticated investors are capable of protecting their own interests and do not require the basic protections of the regulated market. That myth has been dispelled by the current crisis. Not only did "sophisticated" institutional investors load up on toxic mortgage-backed securities and collateralized debt obligations without understanding the risks of those investments, but financial institutions themselves either didn't understand or chose to ignore the risks they were exposing themselves to when they bought toxic assets with borrowed money or funded long-term obligations with short-term financing. By failing to protect their own interests, they damaged not only themselves and their shareholders, but also the financial markets and the global economy as a whole. This situation simply cannot be allowed to continue. Any proposal to address systemic risk must confront this issue head-on in order to be credible.

Other Risk-Related Priorities Should Also Be Addressed

There are other pressing regulatory issues that, while not expressly classified as systemic risk, are directly relevant to any discussion of how best to reduce systemic risk. Chairman Frank has appropriately raised the issue of executive compensation in this context, and CFA supports efforts to reduce compensation incentives that promote excessive risk-taking.

Similarly, improving the reliability of credit ratings while simultaneously reducing our reliance on those ratings is a necessary component of any comprehensive plan to reduce systemic risk. Ideally, some mechanism will be found to reduce the conflicts of interest associated with the agencies' issuer-paid compensation model. Whether or not that is the case, we believe credit rating agencies must face increased accountability for their ratings, the SEC must have increased authority to police their ratings activities to ensure that they follow appropriate due diligence standards in arriving at and maintaining those ratings, and laws and rules that reference the ratings must make clear that reliance on ratings alone does not satisfy due diligence obligations to ensure the appropriateness of the investment.

In addition, CFA believes one of the most important lessons that have been learned regarding the collapse of our financial system is that improved, up-front product-focused regulation will significantly reduce systemic risk. For example, if federal regulators had acted more quickly to prevent abusive sub-prime mortgage loans from flooding the market, it is likely that the current housing and economic crisis would not have been triggered. As a result, we have endorsed the concept advanced by COP Chair Elizabeth Warren and legislation introduced by Senator Richard Durbin and Representative William Delahunt to create an independent financial safety commission to ensure that financial products meet basic standards of consumer protection. Some opponents of this proposal have argued that it would stifle innovation. However, given the damage that recent "innovations" such as liar's loans and Mezzanine CDOs have done to the global economy, this hardly seems like a compelling argument. By distinguishing between beneficial and harmful innovations, such an approach could in our view play a key role in reducing systemic risks.

Congress Needs To Enhance the Quality of Systemic Risk Oversight

In addition to addressing those issues that currently create a significant potential for systemic risk, Congress also needs to enhance the quality of systemic risk oversight going forward. Financial Services Roundtable Chief Executive and CEO Steve Bartlett summed up the problem well in earlier testimony before the Senate Banking Committee when he said that the recent crisis had revealed that our regulatory system "does not provide for sufficient coordination and cooperation among regulators, and that it does not adequately monitor the potential for market failures, high-risk activities, or vulnerable interconnections between firms and markets that can create systemic risk."

In keeping with that diagnosis of the problem, CFA believes the goals of systemic risk regulation should be: 1) to ensure that risks that could threaten the broader financial system are identified and addressed; 2) to reduce the likelihood that a "systemically significant" institution will fail; 3) to strengthen the ability of regulators to take corrective actions before a crisis to prevent imminent failure; and 4) to provide for the orderly failure of non-bank financial institutions. The latter point deserves emphasis, because this appears to be a common misconception: the goal of systemic risk regulation is not to protect certain "systemically significant" institutions from failure, but rather to simultaneously reduce the likelihood of such a failure and ensure that, should it occur, there is a mechanism in place to allow that to happen with the minimum possible disruption to the broader financial markets.

Although there appears to be near universal agreement about the need to improve systemic risk regulation, strong disagreements remain over the best way to accomplish that goal. The remainder of this testimony will address those key questions regarding such issues as who should regulate for systemic risk, who should be regulated, what that regulation should consist of, and how it should be funded. CFA has not yet reached firm conclusions on all of these issues, including on the central question of how systemic risk regulation should be structured. Where our position remains unresolved, we will discuss possible alternatives and the key issues we believe need to be resolved in order to arrive at a conclusion.

Should there be a central systemic risk regulator?

As discussed above, we believe all financial regulators should bear a responsibility to monitor for and mitigate potential systemic risks. Moreover, we believe a regulatory approach that both closes regulatory loopholes and reinvigorates traditional regulation for solvency and consumer and investor protection would go a long way toward accomplishing that goal. Nonetheless, we agree with those who argue that there is a benefit to having some central authority responsible and accountable for overseeing these efforts, if only to coordinate regulatory efforts related to systemic risk and to ensure that this remains a priority once the current crisis is past.

Perhaps the best reason to have one central authority responsible for monitoring systemic risk is that, properly implemented, such an approach offers the best assurance that financial institutions will not be able to exploit newly created gaps in the regulatory structure. Financial institutions have devoted enormous energy and creativity over the past several decades to finding, maintaining, and exploiting gaps in the regulatory structure. Even if Congress does all that we have urged to close the regulatory gaps that now exist, past experience suggests that financial institutions will immediately set out to find new ways to evade legal restrictions.

A central systemic risk regulatory authority could and should be given responsibility for quickly identifying any such activities and assigning them to their appropriate place within the regulatory system. Without such a central authority, regulators may miss activity that does not explicitly fall within their jurisdiction or disputes may arise over which regulator has authority to act. CFA believes designating a central authority responsible for systemic risk regulation offers the best hope of quickly identifying and addressing new risks that emerge that would otherwise be beyond the reach of existing regulations.

Who should it be?

Resolving who should regulate seems to be the most vexing problem in designing a system for improved systemic risk regulation. Three basic proposals have been put forward: 1) assign responsibility for systemic risk regulation to the Fed; 2) create a new market stability regulator; and 3) expand the President's Working Group on Financial Markets (PWG) and give it an explicit mandate to coordinate and oversee regulatory efforts to monitor and mitigate systemic threats. Each approach has its flaws, and it is far easier to poke holes in the various proposals than it is to design a fool-proof system for improving risk regulation.

<u>The Federal Reserve Board</u> – Many people believe the Federal Reserve Board (the "Fed") is the most logical body to serve as systemic risk overseer. Those who favor this approach argue that the Fed has the appropriate mission and expertise, an experienced staff, a long tradition of independence, and the necessary tools to serve in this capacity (e.g., the ability to act as lender of last resort and to provide emergency financial assistance during a financial crisis). Robert C. Pozen summed up this viewpoint succinctly when he testified before the Senate Committee on Homeland Security and Governmental Affairs. He said:

> "Congress should give this role to the Federal Reserve Board because it has the job of bailing out financial institutions whose failure would threaten the whole financial system … If the Federal Reserve Board is going to bail out a broad array of financial institutions, and not just banks, it should have the power to monitor systemic risks so it can help keep institutions from getting to the brink of failure."

Two other, more pragmatic arguments have been cited in favor of giving these responsibilities to the Fed: 1) its ability to obtain adequate resources without relying on the congressional budget process and 2) the relative speed and ease with which this expansion of authority could be accomplished, particularly in comparison with the challenges of establishing a new agency for this purpose.

Others are equally convinced that the Fed is the last agency that should be entrusted with responsibility for systemic risk regulation. Some cite concerns about conflicts inherent in the governance role bank holding companies play in the regional Federal Reserve Banks. Particularly when combined with the Board's closed culture and lack of public accountability, this conflict is seen as likely to undermine public trust in the objectivity of agency decisions about which institutions will be bailed out and which will be allowed to fail in a crisis. Opponents of the Fed as systemic risk regulator also cite a conflict between its role setting monetary policy and its potential role as a systemic risk regulator. One concern is that its role in setting monetary policy requires freedom from political interference, while its role as systemic risk regulator would require full transparency and public accountability. Another involves the question of how the Fed as systemic risk regulator would deal with the Fed as central banker if its monetary policy was contributing to systemic risk (as it clearly did in the run-up to the current crisis).

Others simply point to what they see as the Fed's long history of regulatory failure. This includes not only failures directly related to the current crisis – its failure to address unsound mortgage lending on a timely basis, for example, as well as its failure to prevent banks from holding risky assets in off-balance-sheet special purpose entities and its cheerleading of the rapid expansion of the shadow banking system – but also a perceived past willingness at the Fed to allow banks to hide their losses. According to this argument, Congress ultimately passed FDICIA in 1991 (requiring regulators to close financial institutions before all the capital or equity has been depleted) precisely because the Fed had been unwilling to do so absent that requirement.

Should Congress determine to give systemic risk responsibility to the Fed, we believe it is essential that you take meaningful steps to address what we believe are compelling concerns about this approach. Even some who have spoken in favor of the Fed in this capacity have acknowledged that it will require significant restructuring. As former Federal Reserve Chairman Paul Volcker noted in remarks before the Economic Club of New York last April:

> "If the Federal Reserve is also … to have clear authority to carry effective 'umbrella' oversight of the financial system, internal reorganization will be essential. Fostering the safety and stability of the financial system would be a heavy responsibility paralleling that of monetary policy itself. Providing direction and continuity will require clear lines of accountability …, all backed by a stronger, larger, highly experienced and reasonably compensated professional staff."

CFA concurs that, if systemic risk regulation is to be housed at the Fed, systemic risk regulation must not be relegated to Cinderella status within the agency. Rather, it must be given a high priority within the organization, and significant additional staff dedicated to this task must be hired who have specific risk assessment expertise. Serious thought must also be given to 1) how to resolve disputes between these two potentially competing functions of setting monetary policy and mitigating systemic risks, and 2) how to ensure that systemic risk regulation is carried out with the full transparency and public accountability that it demands.

A New Systemic Risk Regulatory Agency – Some have advocated creation of an entirely new regulatory agency devoted to systemic risk regulation. The idea behind this approach is that it would allow a singular focus on issues of systemic risk, both providing clear accountability and allowing the hiring of specialized staff devoted to this task. Furthermore, such an agency could be structured to avoid the significant concerns associated with designating the Fed to perform this function, including the conflict between monetary policy and systemic risk regulation.

Although it has its advocates, this approach appears to trigger neither the broad support nor the impassioned opposition that the Fed proposal engenders. Those who favor this approach, including Brookings scholar Robert Litan, tend to do so only if it is part of a more radical regulatory restructuring. Adding such an agency to the existing regulatory structure would "add still another cook to the regulatory kitchen, one that is already too crowded, and thus aggravate current jurisdictional frictions," Litan said in recent testimony before the Senate Committee on Homeland Security and Governmental Operations. Moreover, even its advocates tend to acknowledge that it would be a challenge, and possibly an insurmountable challenge, to get such an agency up and running in a timely fashion.

Expanded and Refocused President's Working Group – The other approach that enjoys significant support entails giving an expanded version of the President's Working Group for Financial Markets clear, statutory authority for systemic risk oversight. Its current membership would be expanded to include all the major federal financial regulators as well as representatives of state securities, insurance, and banking officials. By formalizing the PWG's authority through legislation, the group would be directly accountable to Congress, allowing for meaningful congressional oversight.

Among the key benefits of this approach: the council would have access to extensive information about and expertise in all aspects of financial markets. The regulatory bodies with primary day-to-day oversight responsibility would have a direct stake in the panel and its activities, maximizing the chance that they would be fully cooperative with its efforts. For those who believe the Fed must play a significant role in systemic risk regulation, this approach offers the benefit of extensive Fed involvement as a member of the PWG without the problems associated with exclusive Fed oversight of systemic risk.

This approach, while offering attractive benefits, is not without its short-comings. One is the absence of any single party who is solely accountable for regulatory efforts to mitigate systemic risks. Because it would have to act primarily through its member bodies, it could result in an inconsistent and even conflicting approach among regulators. It also raises the risk that systemic risk regulation will not be given adequate priority. In dismissing this approach, Litan acknowledges that it may be the most politically feasible but he maintains: "A college of regulators clearly violates the Buck Stops Here principle, and is a clear recipe for jurisdictional battles and after-the-fact finger pointing."

Despite the many attractions of this approach, this latter point is particularly compelling, in our view. Regulators have a long history of jurisdictional disputes. There is no reason to believe those problems would simply dissipate under this arrangement. Decisions about who has responsibility for newly emerging activities would likely be particularly contentious. If Congress were to decide to adopt this approach, it would need to set out some clear mechanism for resolving any such disputes. Alternatively, it could combine this approach with enhanced systemic risk authority for either the Fed or a new agency, as the Financial Services Roundtable has suggested, providing that agency with the benefit of the panel's broad expertise and improving coordination of regulatory efforts in this area.

FDIC – A major reason federal authorities were forced to improvise in managing the events of the past year is that we lack a mechanism for the orderly unwinding of non-bank financial institutions that is comparable to the authority that the FDIC has for banks. Most systemic risk plans seem to contemplate expanding FDIC authority to include non-bank financial institutions, although some would house this authority within a systemic risk regulator. CFA believes this is an essential component of a comprehensive plan for enhanced systemic risk regulation. While we have not worked out exactly how this should operate, we believe the

FDIC, the systemic risk regulator, or the two agencies working together must also have authority to intervene when failure appears imminent to require corrective actions.

A Systemic Risk Advisory Panel – One of the key criticisms of making the Fed the systemic risk regulator is its dismal regulatory record. But if we limited our selections to those regulators with a credible record of identifying and addressing potential systemic risks while they are still at a manageable stage, we'd be forced to start from scratch in designing a new regulatory body. And there is no guarantee we would get it right this time.

A number of academics and others outside the regulatory system were far ahead of the regulators in recognizing the risks associated with unsound mortgage lending, unreliable ratings on mortgage-backed securities and CDOs, the build-up of excessive leverage, the questionable risk management practices of investment banks, etc. Regardless of what approach Congress chooses to adopt for systemic risk oversight, we believe it should also mandate creation of a high-level advisory panel on systemic risk. Such a panel could include academics and other analysts from a variety of disciplines with a reputation for independent thinking and, preferably, a record of identifying weaknesses in the financial system. Names such as Nouriel Roubini, Frank Partnoy, Joseph Mason, and Joshua Rosner immediately come to mind as attractive candidates for such a panel.

The panel would be charged with conducting an on-going and independent assessment of systemic risks to supplement the efforts of the regulators. It would report periodically to both Congress and the regulatory agencies on its findings. It could be given privileged access to information gathered by the regulators to use in making its assessment. When appropriate, it might recommend either legislative or regulatory changes with a goal of reducing risks to the financial system. CFA believes such an approach would greatly enhance the accountability of regulators and reduce the risks of group-think and complacency. We urge you to include this as a component of your regulatory reform plan.

Who should be regulated?

The debate over who should be regulated for systemic risk basically boils down to two main points of view. Those who see systemic risk regulation as something that kicks in during or on the brink of a crisis, to deal with the potential failure of one or more financial institutions, tend to favor a narrower approach focused on a few large or otherwise "systemically important" institutions. In contrast, those who see systemic risk regulation as something that is designed, first and foremost, to prevent risks from reaching that degree of severity tend to favor a much more expansive approach. Recognizing that systemic risk can derive from a variety of different practices, proponents of this view argue that all forms of financial activity must be subject to systemic risk regulation and that the systemic risk regulator must have significant flexibility and authority to determine the extent of its reach.

CFA falls firmly into the latter camp. We are not alone; this expansive view of systemic risk jurisdiction has many supporters, at least when it comes to the regulator's authority to monitor the markets for systemic risk. The Government Accountability Office, for example, has said that such efforts "should cover all activities that pose risks or are otherwise important to meeting regulatory goals." Bartlett of the Financial Services Roundtable summed it up well in his testimony when he said that:

> "… authority to collect information should apply not only to depository institutions, but also to all types of financial services firms, including broker/dealers, insurance companies, hedge funds, private equity firms, industrial loan companies, credit unions, and any other financial services firms that facilitate financial flows (e.g., transactions, savings, investments, credit, and financial protection) in our economy. Also, this authority should not be based upon the size of an institution. It is possible that a number of smaller institutions could be engaged in activities that collectively pose a systemic risk."

The case for giving a systemic risk regulator broad authority to monitor the markets for systemic risk is obvious, in our opinion. Failure to grant a regulator this broad authority risks allowing risks to grow up outside the clear jurisdiction of functional regulators, a situation financial institutions have shown themselves to be very creative at exploiting.

While the case for allowing the systemic risk regulator broad authority to monitor the financial system as a whole seems obvious, the issue of whether to also grant that regulator authority to constrain risky conduct wherever they find it is more complex. Those who favor a narrower approach argue that the proper focus of any such regulatory authority should be limited to those institutions whose failure would be likely to create a systemic risk. This view is based on the sentiment that, if an institution is too big to fail, it must be regulated. While CFA shares the view that those firms that are "too big to fail" must be regulated, we take that view one step further. As we have discussed above, we believe that the best way to reduce systemic risk is to ensure that all financial activity is regulated to ensure that it is conducted according to basic principles of transparency, fair dealing, and accountability.

Those like Litan who favor a narrower approach focused on "systemically important" institutions defend it against charges that it creates unacceptable moral hazard by arguing that it is essentially impossible to expand on the moral hazard that has already been created by recent federal bailouts simply by formally designating certain institutions as systemically significant. We agree that, based on recent events and unless the approach to systemic risk is changed, the market will assume that large firms will be rescued, just as the market rightly assumed for years, despite assurances to the contrary, that the government would stand behind the GSEs. Nonetheless, we do not believe it follows that the appropriate approach to systemic risk regulation is to focus exclusively on these institutions that are most likely to receive a bailout. Instead, we believe it is essential to attack risks more broadly, before institutions are threatened with failure and, to the degree possible, to eliminate the perception that large institutions will always be rescued. The latter goal could be addressed both by reducing the practices that make institutions systemically significant and by creating a mechanism to allow their orderly failure.

Ultimately, we believe a regulatory approach that relies on identifying institutions in advance that are systemically significant is simply unworkable. The fallibility of this approach was demonstrated conclusively in the wake of the government's determination that Lehman Brothers, unlike Bear Stearns, was not too big to fail. As Richard Baker, President and CEO of the Managed Funds Association, said in his testimony before the House Capital Markets Subcommittee, "There likely are entities that would be deemed systemically relevant … whose failure would not threaten the broader financial system." We also agree with NAIC Chief Executive Officer Therese Vaughn, who said in testimony at the same hearing, "In our view, an entity poses systemic risk when that entity's activities have the ability to ripple through the broader financial system and trigger problems for other counterparties, such that extraordinary action is necessary to mitigate it."

The factors that might make an institution systemically important are complex – going well beyond asset size and even degree of leverage to include such considerations as nature and degree of interconnectivity to other financial institutions, risks of activities engaged in, nature of compensation practices, and degree of concentration of financial assets and activities, to name just a few. Trying to determine in advance where that risk is likely to arise would be all but impossible. And trying to maintain an accurate list of systemically important institutions going forward, considering the complex array of factors that are relevant to that determination, would require constant and detailed monitoring of institutions on the borderline, would be extremely time-consuming, and ultimately would almost certainly allow certain risky institutions and practices to fall through the cracks.

How should they regulate?

There are three key issues that must be addressed in determining the appropriate procedures for regulating to mitigate systemic risk:

- Should responsibility and authority to regulate for systemic risks kick in only in a crisis, or on the brink of a crisis, or should it be an on-going, day-to-day obligation of financial regulators?

- What regulatory tools should be available to a systemic risk regulator? For example, should a designated systemic risk regulator have authority to take corrective actions, or should it be required (or encouraged) to work through functional regulators?

- If a designated systemic risk regulator has authority to require corrective actions, should it apply generally to all financial institutions, products, and practices or should it be limited to a select population of systemically important institutions?

When the Treasury Department issued its Blueprint for regulatory reform a year ago, it proposed to give the Federal Reserve broad new authority to regulate systemic risk but only in a crisis. Despite the sweeping scope of its restructuring proposals, Treasury clearly envisioned a strictly limited role within systemic risk regulation for regulatory interventions exercised primarily through its role as lender of last resort. Although there are a few who continue to advocate a version of that viewpoint, we believe events since the Blueprint's release have conclusively proven the disadvantages of this approach. As Volcker stated in his New York Economic Club speech: "I do not see how that responsibility can be turned on only at times of turmoil – in effect when the horse has left the barn." We share that skepticism, convinced like the authors of the COP Report that, "Systemic risk needs to be managed before moments of crisis, by regulators who have clear authority and the proper tools."

As noted above, most parties appear to agree that a systemic risk regulator must have broad authority to survey all areas of financial markets and the flexibility to respond to emerging areas of potential risk. CFA shares this view, believing it would be both impractical and dangerous to require the regulator to go back to Congress each time it sought to extend its jurisdiction in response to changing market conditions. Others have described a robust set of additional tools that regulators should have to minimize systemic risks. As the Group of 30 noted in its report on regulatory reform: "… a legal regime should be established to provide regulators with authority to require early warnings, prompt corrective actions, and orderly closings" of certain financial institutions. The specific regulatory powers various parties have recommended as part of a comprehensive framework for systemic risk regulation include authority to:

- Set capital, liquidity, and other regulatory requirements directly related to risk management;
- Require firms to pay some form of premium, much like the premiums banks pay to support the federal deposit insurance fund, adjusted to reflect the bank's size, leverage, and concentration, as well as the risks associated with its activities;
- Directly supervise at least certain institutions;
- Act as lender of last resort with regard to institutions at risk of failure;
- Act as a receiver or conservator of a failed non-depository organization and to place the organization in liquidation or take action to restore it to a sound and solvent condition;
- Require corrective actions at troubled institutions that are similar to those provided for in FDICIA;
- Make regular reports to Congress; and
- Take enforcement actions, with powers similar to what Federal Reserve currently has over bank holding companies.

Without evaluating each recommendation individually or in detail, CFA believes this presents an appropriately comprehensive view of the tools necessary for systemic risk regulation.

Most of those who have commented on this topic would give at least some of this responsibility and authority – such as demanding corrective actions to reduce risks – directly to a systemic risk regulator. Others would require in all but the most extreme circumstances that a systemic risk regulator exercise this authority only in cooperation with functional regulators. Both approaches have advantages and disadvantages. Giving a systemic risk regulator this authority would ensure consistent application of standards and establish a clear line of accountability for decision-making in this area. But it would also demand, perhaps unrealistically, that the regulator have a detailed understanding of how those standards would best be implemented in a vast variety of firms and situations. Relying on functional regulators to act avoids the latter problem but sets up a potential for jurisdictional conflicts as well as inconsistent and delayed implementation. If Congress decides to adopt the latter approach, it will need to make absolutely clear what authority the systemic risk regulator has to require its regulatory partners to take appropriate action. Without that clarification, disputes over jurisdiction are inevitable, and inconsistencies and conflicts are bound to emerge. It would also be doubly important under such an approach to ensure that gaps in the regulatory framework are closed and that all regulators share a responsibility for reducing systemic risk.

Many of those who would give a systemic risk regulator this direct authority to demand corrective actions would limit its application to a select population of systemically important institutions. The Securities Industry and Financial Markets Association has advocated, for example, that the resolution system for non-bank firms apply only to "the few organizations whose failure might reasonably be considered to pose a threat to the financial system." In testimony before the House Capital Markets Subcommittee, SIFMA President and CEO T. Timothy Ryan, Jr. also suggested that the systemic risk regulator should only directly supervise systemically important financial institutions.

Such an approach requires a systemic risk regulator to identify in advance those institutions that pose a systemic risk. Others express strong opposition to this approach. As former Congressman Baker of the MFA said in his recent House subcommittee testimony:

> "An entity that is perceived by the market to have a government guarantee, whether explicit or implicit, has an unfair competitive advantage over other market participants. We strongly believe that the systemic risk regulator should implement its authority in a way that avoids this possibility and also avoids the moral hazards that can result from a company having an ongoing government guarantee against failure."

Unfortunately, the recent actions the government was called on to take to rescue a series of non-bank financial institutions has already created that implied backing. Simply refraining from designating certain institutions as systemically significant will not be sufficient to dispel that expectation, and it would at least provide the opportunity to subject those firms to tougher standards and enhanced oversight. As discussed above, however, CFA believes this approach to be unworkable.

That is a key reason why we believe it is absolutely essential to provide for corrective action and resolution authority as part of a comprehensive plan for enhanced systemic risk regulation. As money manager Jonathan Tiemann argued in a recent article entitled "The Wall Street Vortex":

> "Some institutions are so large that their failure would imperil the financial system. As such, they enjoy an implicit guarantee, which could … force us to nationalize their losses. But we need for all financial firms that run the risk of failure to be able to do so without causing a widespread financial meltdown. The most interesting part of the debate should be on this point, whether we could break these firms into smaller pieces, limit their activities, or find a way to compartmentalize the risks that their various business units take."

CFA believes this is an issue that deserves more attention than it has garnered to date. One option is to try to maximize the incentives of private parties to avoid risks, for example by subjecting financial institutions to risk-based capital requirements and premium payments. To serve as a significant deterrent to risk, these requirements would have to ratchet up dramatically as institutions grew in size, took on risky assets, increased their level of leverage, or engaged in other activities deemed risky by regulators. It has been suggested, for example, that the Fed could have prevented the rapid growth in use of over-the-counter credit default swaps by financial institutions if it had adopted this approach. It could, for example, have imposed capital standards for use of OTC derivatives that were higher than the margin requirements associated with trading the same types of derivatives on a clearinghouse and designed to reflect the added risks associated with trading in the over-the-counter markets. In order to minimize the chances that institutions will avoid becoming too big or too inter-connected to fail, CFA urges you to include such incentives as a central component of your systemic risk regulation legislation.

Conclusion

Decades of Wall Street excess unchecked by reasonable and prudential regulation have left our markets vulnerable to systemic shock. The United States, and indeed the world, is still reeling from the effects of the latest and most severe of a long series of financial crises. Only a fundamental change in regulatory approach will turn this situation around. While structural changes are a part of that solution, they are by no means the most important aspect. Rather, returning to a regulatory approach that recognizes both the disastrous consequences of allowing markets to self-regulate and the necessity of strong and effective governmental controls to rein in excesses is absolutely essential to achieving this goal.