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STATEMENT OF

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on

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Chairman Dodd, Ranking Member Shelby and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the need to modernize and reform our financial regulatory system.

The events that have unfolded over the past two years have been extraordinary. A series of economic shocks have produced the most challenging financial crisis since the Great Depression. The widespread economic damage has called into question the fundamental assumptions regarding financial institutions and their supervision that have directed our regulatory efforts for decades. 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. In addition, the significant growth of unsupervised financial activities outside the traditional banking system has hampered effective regulation.

Our current system has clearly failed in many instances to manage risk properly and to provide stability. U.S. regulators have broad powers to supervise financial institutions and markets and to limit many of the activities that undermined our financial system, but there are significant gaps, most notably regarding very large insurance companies and private equity funds. However, we must also acknowledge that 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. Perhaps most importantly, failure to ensure that financial products were appropriate and sustainable for consumers has caused significant problems not only for those consumers but for the safety and soundness of financial institutions. Moreover, some parts of the current financial system, for example, over the counter derivatives, are by statute, mostly excluded from federal regulation.

In the face of the current crisis, regulatory gaps argue for some kind of comprehensive regulation or oversight of all systemically important financial firms. But, the failure to utilize existing authorities by regulators casts doubt on whether simply entrusting power in a single systemic risk regulator will sufficiently address the underlying causes of our past supervisory failures. We need to recognize that simply creating a new systemic risk regulator is a not a panacea. The most important challenge is to find ways to impose greater market discipline on systemically important institutions. The solution must involve, first and foremost, a legal mechanism for the orderly resolution of these institutions similar to that which exists for FDIC insured banks. In short, we need an end to too big to fail.

It is time to examine the more fundamental issue of whether there are economic benefits to institutions whose failure can result in systemic issues for the economy. Because of their concentration of economic power and interconnections through the

financial system, the management and supervision of institutions of this size and complexity has proven to be problematic. Taxpayers have a right to question how extensive their exposure should be to such entities.

The problems of supervising large, complex financial institutions are compounded by the absence of procedures and structures to effectively resolve them in an orderly fashion when they end up in severe financial trouble. Unlike the clearly defined and proven statutory powers that exist for resolving insured depository institutions, the current bankruptcy framework available to resolve large complex non-bank financial entities and financial holding companies was not designed to protect the stability of the financial system. This is important because, in the current crisis, bank holding companies and large non-bank entities have come to depend on the banks within the organizations as a source of strength. Where previously the holding company served as a source of strength to the insured institution, these entities now often rely on a subsidiary depository institution for funding and liquidity, but carry on many systemically important activities outside of the bank that are managed at a holding company level or non-bank affiliate level.

While the depository institution could be resolved under existing authorities, the resolution would cause the holding company to fail and its activities would be unwound through the normal corporate bankruptcy process. Without a system that provides for the orderly resolution of activities outside of the depository institution, the failure of a systemically important holding company or non-bank financial entity will create

additional instability as claims outside the depository institution become completely illiquid under the current system.

In the case of a bank holding company, the FDIC has the authority to take control of only the failing banking subsidiary, protecting the insured depositors. However, many of the essential services in other portions of the holding company are left outside of the FDIC's control, making it difficult to operate the bank and impossible to continue funding the organization's activities that are outside the bank. In such a situation, where the holding company structure includes many bank and non-bank subsidiaries, taking control of just the bank is not a practical solution.

If a bank holding company or non-bank financial holding company is forced into or chooses to enter bankruptcy for any reason, the following is likely to occur. In a Chapter 11 bankruptcy, there is an automatic stay on most creditor claims, with the exception of specified financial contracts (futures and options contracts and certain types of derivatives) that are subject to termination and netting provisions, creating illiquidity for the affected creditors. The consequences of a large financial firm filing for bankruptcy protection are aptly demonstrated by the Lehman Brothers experience. As a result, neither taking control of the banking subsidiary or a bankruptcy filing of the parent organization is currently a viable means of resolving a large, systemically important financial institution, such as a bank holding company. This has forced the government to improvise actions to address individual situations, making it difficult to address systemic problems in a coordinated manner and raising serious issues of fairness.

My testimony will examine some steps that can be taken to reduce systemic vulnerabilities by strengthening supervision and regulation and improving financial market transparency. I will focus on some specific changes that should be undertaken to limit the potential for excessive risk in the system, including identifying systemically important institutions, creating incentives to reduce the size of systemically important firms and ensuring that all portions of the financial system are under some baseline standards to constrain excessive risk taking and protect consumers. I will explain why an independent special failure resolution authority is needed for financial firms that pose systemic risk and describe the essential features of such an authority. I also will suggest improvements to consumer protection that would improve regulators' ability to stem fraud and abusive practices. Next, I will discuss other areas that require legislative changes to reduce systemic risk -- the over-the-counter (OTC) derivatives market and the money market mutual fund industry. And, finally, I will address the need for regulatory reforms related to the originate-to-distribute model, executive compensation in banks, fair-value accounting, credit rating agencies and counter-cyclical capital policies..

Addressing Systemic Risk

Many have suggested that the creation of a systemic risk regulator is necessary to address key flaws in the current supervisory regime. According to the proposals, this new regulator would be tasked with monitoring large or rapidly increasing exposures -- such as to sub-prime mortgages -- across firms and markets, rather than only at the level of individual firms or sectors; and analyzing possible spillovers among financial firms or

between firms and markets, such as the mutual exposures of highly interconnected firms. Additionally, the proposals call for such a regulator to have the authority to obtain information and examine banks and key financial market participants, including non-bank financial institutions that may not be currently subject to regulation. Finally, the systemic risk regulator would be responsible for setting standards for capital, liquidity, and risk management practices for the financial sector.

Changes in our regulatory and supervisory approach are clearly warranted, but Congress should proceed carefully and deliberately in creating a new systemic risk regulator. Many of the economic challenges we are facing continue and new aspects of interconnected problems continue to be revealed. It will require great care to address evolving issues in the midst of the economic storm and to avoid unintended consequences. In addition, changes that build on existing supervisory structures and authorities -- that fill regulatory voids and improve cooperation -- can be implemented more quickly and more effectively.

While I fully support the goal of having an informed, forward looking, proactive and analytically capable regulatory community, looking back, if we are honest in our assessment, it is clear that U.S. regulators already had many broad powers to supervise financial institutions and markets and to limit many of the activities that undermined our financial system. For various reasons, these powers were not used effectively and as a consequence supervision was not sufficiently proactive.

There are many examples of situations in which existing powers could have been used to prevent the financial system imbalances that led to the current financial crisis. For instance, supervisory authorities have had the authority under the Home Ownership and Equity Protection Act to regulate the mortgage industry since 1994. Comprehensive new regulations intended to limit the worst practices in the mortgage industry were not issued until well into the onset of the current crisis. Failure to address lax lending standards among non-bank mortgage companies created market pressure on banks to also relax their standards. Bank regulators were late in addressing this phenomenon.

In other important examples, federal regulatory agencies have had consolidated supervisory authority over institutions that pose a systemic risk to the financial system; yet they did not to exercise their authorities in a manner that would have enabled them to anticipate the risk concentrations in the bank holding companies, investment bank holding companies and thrift holding companies they supervise. Special purpose financial intermediaries -- such as structured investment vehicles (SIVs) -- played an important role in funding and aggregating the credit risks that are at the core of the current crisis. These intermediaries were formed outside the banking organizations so banks could recognize asset sales and take the assets off the balance sheet, or remotely originate assets to keep off the balance sheet and thereby avoid minimum regulatory capital and leverage ratio constraints. Because they were not on the bank's balance sheet and to the extent that they were managed outside of the bank by the parent holding company, SIVs escaped scrutiny from the bank regulatory agencies.

With hindsight, all of the regulatory agencies will focus and find ways to better exercise their regulatory powers. Even though the entities and authorities that have been proposed for a systemic regulator largely existed, the regulatory community did not appreciate the magnitude and scope of the potential risks that were building in the system. Having a systemic risk regulator that would look more broadly at issues on a macro-prudential basis would be of incremental benefit, but the success of any effort at reform will ultimately rely on the willingness of regulators to use their authorities more effectively and aggressively.

The lack of regulatory foresight was not specific to the United States. As a recent report on financial supervision in the European Union noted, financial supervisors frequently did not have, and in some cases did not insist on obtaining -- or received too late -- all of the relevant information on the global magnitude of the excess leveraging that was accumulating in the financial system.[1] Further, they did not fully understand or evaluate the size of the risks, or share their information properly with their counterparts in other countries. The report concluded that insufficient supervisory and regulatory resources combined with an inadequate mix of skills as well as different systems of national supervision made the situation worse. In interpreting this report, it is important to recall that virtually every European central bank is required to assess and report economic and financial system conditions and anticipate emerging financial-sector risks.

[1] European Union, Report of the High-level Group on Financial Supervision in the EU, J. de Larosière, Chairman, Brussels, 25 February 2009.

With these examples in mind, we should recognize that while establishing a systemic risk regulator is important, it is far from clear that it will prevent a future systemic crisis.

Limiting Risk by Limiting Size and Complexity

Before considering the various proposals to create a systemic risk regulator, Congress should examine a more fundamental question of whether there should be limitations on the size and complexity of institutions whose failure would be systemically significant. Over the past two decades, a number of arguments have been advanced about why financial organizations should be allowed to become larger and more complex. These reasons include being able to take advantage of economies of scale and scope, diversifying risk across a broad range of markets and products, and gaining access to global capital markets. It was alleged that the increased size and complexity of these organizations could be effectively managed using new innovations in quantitative risk management techniques. Not only did institutions claim that they could manage these new risks, they also argued that often the combination of diversification and advanced risk management practices would allow them to operate with markedly lower capital buffers than were necessary in smaller, less-sophisticated institutions. Indeed many of these concepts were inherent in the Basel II Advanced Approaches, resulting in reduced capital requirements. In hindsight, it is now clear that the international regulatory community relied too heavily on diversification and risk management when setting minimum regulatory capital requirements for large complex financial institutions.

Notwithstanding expectations and industry projections for gains in financial efficiencies, economies of scale seem to be reached at levels far below the size of today's largest financial institutions. Also, efforts designed to realize economies of scope have not lived up to their promise. In some instances, the complex institutional combinations permitted by the Gramm-Leach-Bliley (GLB) legislation were unwound because they failed to realize anticipated economies of scope. The latest studies of economies produced by increased scale and scope find that most banks could improve their cost efficiency more by concentrating their efforts on reducing operational inefficiencies.

There also are limits to the ability to diversify risk using securitization, structured finance and derivatives. No one disputes that there are benefits to diversification for smaller and less-complex institutions, but as institutions become larger and more complex, the ability to diversify risk is diminished. When a financial system includes a small number of very large complex organizations, the system cannot be well-diversified. As institutions grow in size and importance, they not only take on a risk profile that mirrors the risk of the market and general economic conditions, but they also concentrate risk as they become the only important counterparties to many transactions that facilitate financial intermediation in the economy. The fallacy of the diversification argument becomes apparent in the midst of financial crisis when these large complex financial organizations -- because they are so interconnected -- reveal themselves as a source of risk in the system.

Managing the transition to a safer system

If large complex organizations concentrate risk and do not provide market efficiencies, it may be better to address systemic risk by creating incentives to encourage a financial industry structure that is characterized by smaller and therefore less systemically important financial firms, for instance, by imposing increasing financial obligations that mirror the heightened risk posed by large entities.

Identifying systemically important firms

To be able to implement and target the desired changes, it becomes important to identify characteristics of a systemically important firm. A recent report by the Group of Thirty highlights the difficulties that are associated with a fixed common definition of what comprises a systemically important firm. What constitutes systemic importance is likely to vary across national boundaries and change over time. Generally, it would include any firm that constitutes a significant share of their market or the broader financial system. Ultimately, identification of what is systemic will have to be decided within the structure created for systemic risk regulation, but at a minimum, should rely on triggers based on size and counterparty concentrations.

Increasing financial obligations to reflect increasing risk

To date, many large financial firms have been given access to vast amounts of public funds. Obviously, changes are needed to prevent this situation from reoccurring and to ensure that firms are not rewarded for becoming, in essence, too big to fail. Rather, they should be required to offset the potential costs to society.

In contrast to the capital standards implied in the Basel II Accord, systemically important firms should face additional capital charges based on both size and complexity. In addition, they should be subject to higher Prompt Corrective Action (PCA) limits under U.S. laws. Regulators should judge the capital adequacy of these firms, taking into account off-balance-sheet assets and conduits as if these risks were on balance sheet.

Next steps

Currently, not all parts of the financial system are subject to federal regulation. Insurance company regulation is conducted at the state level. There is, therefore, no federal regulatory authority specifically designed to provide comprehensive prudential supervision for large insurance companies. Hedge funds and private equity firms are typically designed to operate outside the regulatory structures that would otherwise constrain their leverage and activities. This is of concern not only for the safety and soundness of these unregulated firms, but for regulated firms as well. Some of banking organizations' riskier strategies, such as the creation of SIVs, may have been driven by a

desire to replicate the financial leverage available to less regulated entities. Some of these firms by virtue of their gross balance sheet size or by their dominance in particular markets can pose systemic risks on their own accord. Many others are major participants in markets and business activities that may contribute to a systemic collapse. This loophole in the regulatory net cannot continue. It is important that all systemically important financial firms, including hedge funds, insurance companies, investment banks, or bank or thrift holding companies, be subject to prudential supervision, including across the board constraints on the use of financial leverage.

New Resolution Procedures

There is clearly a need for a special resolution regime, outside the bankruptcy process, for financial firms that pose a systemic risk, just as there is for commercial banks and thrifts. As noted above, beyond the necessity of capital regulation and prudential supervision, having a mechanism for the orderly resolution of institutions that pose a systemic risk to the financial system is critical. Creating a resolution regime that could apply to any financial institution that becomes a source of systemic risk should be an urgent priority.

The differences in outcomes from the handling of Bear Stearns and Lehman Brothers demonstrate that authorities have no real alternative but to avoid the bankruptcy process. When the public interest is at stake, as in the case of systemically important entities, the resolution process should support an orderly unwinding of the institution in a

way that protects the broader economic and taxpayer interests, not just private financial interests.

In creating a new resolution regime, we must clearly define roles and responsibilities and guard against creating new conflicts of interest. In the case of banks, Congress gave the FDIC backup supervisory authority and the power to self-appoint as receiver, recognizing there might be conflicts between a primary regulators' prudential responsibilities and its willingness to recognize when an institution it supervises needs to be closed. Thus, the new resolution authority should be independent of the new systemic risk regulator.

This new authority should also be designed to limit subsidies to private investors (moral hazard). If financial assistance outside of the resolution process is granted to systemically important firms, the process should be open, transparent and subject to a system of checks and balances that are similar to the systemic-risk exception to the least-cost test that applies to insured financial institutions. No single government entity should be able to unilaterally trigger a resolution strategy outside the defined parameters of the established resolution process.

Clear guidelines for this process are needed and must be adhered to in order to gain investor confidence and protect public and private interests. First, there should be a clearly defined priority structure for settling claims, depending on the type of firm. Any resolution should be subject to a cost test to minimize any public loss and impose losses

according to the established claims priority. Second, it must allow continuation of any systemically significant operations. The rules that govern the process, and set priorities for the imposition of losses on shareholders and creditors should be clearly articulated and closely adhered to so that the markets can understand the resolution process with predicable outcomes.

The FDIC's authority to act as receiver and to set up a bridge bank to maintain key functions and sell assets offers a good model. A temporary bridge bank allows the government to prevent a disorderly collapse by preserving systemically significant functions. It enables losses to be imposed on market players who should appropriately bear the risk. It also creates the possibility of multiple bidders for the bank and its assets, which can reduce losses to the receivership.

The FDIC has the authority to terminate contracts upon an insured depository institution's failure, including contracts with senior management whose services are no longer required. Through its repudiation powers, as well as enforcement powers, termination of such management contracts can often be accomplished at little cost to the FDIC. Moreover, when the FDIC establishes a bridge institution, it is able to contract with individuals to serve in senior management positions at the bridge institution subject to the oversight of the FDIC. The new resolution authority should be granted similar statutory authority in the resolution of financial institutions.

Congress should recognize that creating a new separate authority to administer systemic resolutions may not be economic or efficient. It is unlikely that the separate resolution authority would be used frequently enough to justify maintaining an expert and motivated workforce as there could be decades between systemic events. While many details of a special resolution authority for systemically important financial firms would have to be worked out, a new systemic resolution regime should be funded by fees or assessments charged to systemically important firms. In addition, consistent with the FDIC's powers with regard to insured institutions, the resolution authority should have backup supervisory authority over those firms which it may have to resolve.

Consumer protection

There can no longer be any doubt about the link between protecting consumers from abusive products and practices and the safety and soundness of the financial system. Products and practices that strip individual and family wealth undermine the foundation of the economy. As the current crisis demonstrates, increasingly complex financial products combined with frequently opaque marketing and disclosure practices result in problems not just for consumers, but for institutions and investors as well.

To protect consumers from potentially harmful financial products, a case has been made for a new independent financial product safety commission. Certainly, more must be done to protect consumers. We could support the establishment of a new entity to establish consistent consumer protection standards for banks and non-banks. However,

we believe that such a body should include the perspective of bank regulators as well as non-bank enforcement officials such as the FTC. However, as Congress considers the options, we recommend that any new plan ensure that consumer protection activities are aligned and integrated with other bank supervisory information, resources, and expertise, and that enforcement of consumer protection rules for banks be left to bank regulators.

The current bank regulation and supervision structure allows the banking agencies to take a comprehensive view of financial institutions from both a consumer protection and safety-and-soundness perspective. Banking agencies' assessments of risks to consumers are closely linked with and informed by a broader understanding of other risks in financial institutions. Conversely, assessments of other risks, including safety and soundness, benefit from knowledge of basic principles, trends, and emerging issues related to consumer protection. Separating consumer protection regulation and supervision into different organizations would reduce information that is necessary for both entities to effectively perform their functions. Separating consumer protection from safety and soundness would result in similar problems.

Our experience suggests that the development of policy must be closely coordinated and reflect a broad understanding of institutions' management, operations, policies, and practices -- and the bank supervisory process as a whole. Placing consumer protection policy-setting activities in a separate organization, apart from existing expertise and examination infrastructure, could ultimately result in less effective protections for consumers.

One of the fundamental principles of the FDIC's mission is to serve as an independent agency focused on maintaining consumer confidence in the banking system. The FDIC plays a unique role as deposit insurer, federal supervisor of state nonmember banks and savings institutions, and receiver for failed depository institutions. These functions contribute to the overall stability of and consumer confidence in the banking industry. With this mission in mind, if given additional rulemaking authority, the FDIC is prepared to take on an expanded role in providing consumers with stronger protections that address products posing unacceptable risks to consumers and eliminate gaps in oversight.

Under the Federal Trade Commission (FTC) Act, only the Federal Reserve Board (FRB) has authority to issue regulations applicable to banks regarding unfair or deceptive acts or practices, and the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA) have sole authority with regard to the institutions they supervise. The FTC has authority to issue regulations that define and ban unfair or deceptive acts or practices with respect to entities other than banks, savings and loan institutions, and federal credit unions. However, the FTC Act does not give the FDIC authority to write rules that apply to the approximately 5,000 entities it supervises -- the bulk of state banks -- nor to the OCC for their 1,700 national banks. Section 5 of the FTC Act prohibits "unfair or deceptive acts or practices in or affecting commerce." It applies to all persons engaged in commerce, whether banks or non-banks, including mortgage lenders and credit card issuers. While the "deceptive" and "unfair" standards are independent of one another, the prohibition against these practices applies to all types

of consumer lending, including mortgages and credit cards, and to every stage and activity, including product development, marketing, servicing, collections and the termination of the customer relationship.

In order to further strengthen the use of the FTC Act's rulemaking provisions, the FDIC has recommended that Congress consider granting Section 5 rulemaking authority to all federal banking regulators. By limiting FTC rulemaking authority to the FRB, OTS and NCUA, current law excludes participation by the primary federal supervisors of about 7,000 banks. The FDIC's perspective -- as deposit insurer and as supervisor for the largest number of banks, many of whom are small community banks -- would provide valuable input and expertise to the rulemaking process. The same is true for the OCC, as supervisor of some of the nation's largest banks. As a practical matter, these rulemakings would be done on an interagency basis and would benefit from the input of all interested parties.

In the alternative, if Congress is inclined to establish an independent financial product commission, it should leverage the current regulatory authorities that have the resources, experience, and legislative power to enforce regulations related to institutions under their supervision, so it would not be necessary to create an entirely new enforcement infrastructure. In fact, in creating a financial products safety commission, it would be beneficial to include the FDIC and principals from other financial regulatory agencies on the commission's board. Such a commission should be required to submit

periodic reports to Congress on the effectiveness of the consumer protection activities of the commission and the bank regulators.

Whether or not Congress creates a new commission, it is essential that there be uniform standards for financial products whether they are offered by banks or non-banks. These standards must apply across all jurisdictions and issuers, otherwise gaps create competitive pressures to reduce standards, as we saw with mortgage lending standards. Clear standards also permit consistent enforcement that protects consumers and the broader financial system.

Finally, in the on-going process to improve consumer protections, it is time to examine curtailing federal preemption of state consumer protection laws. Federal preemption of state laws was seen as a way to improve efficiencies for financial firms who argued that it lowered costs for consumers. While that may have been true in the short run, it has now become clear that abrogating sound state laws, particularly regarding consumer protection, created an opportunity for regulatory arbitrage that frankly resulted in a "race-to-the-bottom" mentality. Creating a "floor" for consumer protection, based on either appropriate state or federal law, rather than the current system that establishes a ceiling on protections would significantly improve consumer protection. Perhaps reviewing the existing web of state and federal laws related to consumer protections and choosing the most appropriate for the "floor" could be one of the initial priorities for a financial products safety commission.

Changing the OTC market and protecting of money market mutual funds

Two areas that require legislative changes to reduce systemic risk are the OTC derivatives market and the money market mutual fund industry.

Credit derivatives markets and systemic risk

Beyond issues of size and resolution schemes for systemically important institutions, recent events highlight the need to revisit the regulation and oversight of credit derivative markets. Credit derivatives provide investors with instruments and markets that can be used to create tremendous leverage and risk concentration without any means for monitoring the trail of exposure created by these instruments. An individual firm or a security from a sub-prime, asset-backed or other mortgage-backed pool of loans may have only $50 million in outstanding par value and yet, the over-the-counter markets for credit default swaps (CDS) may create hundreds of millions of dollars in individual CDS contracts that reference that same debt. At the same time, this debt may be referenced in CDS Index contracts that are created by OTC dealers which creates additional exposure. If the referenced firm or security defaults, its bond holders will likely lose some fraction of the $50 million par value, but CDS holders face losses that are many times that amount.

Events have shown that the CDS markets are a source of systemic risk. The market for CDS was originally set up as an inter-bank market to exchange credit risk without selling the underlying loans, but it has since expanded massively to include

hedge funds, insurance companies, municipalities, public pension funds and other financial institutions. The CDS market has expanded to include OTC index products that are so actively traded that they spawned a Chicago Board of Trade futures market contract. CDS markets are an important tool for hedging credit risk, but they also create leverage and can multiply underlying credit risk losses. Because there are relatively few CDS dealers, absent adequate risk management practices and safeguards, CDS markets can also create counterparty risk concentrations that are opaque to regulators and financial institutions.

Our views on the need for regulatory reform of the CDS and related OTC derivatives markets are aligned with the recommendations made in the recent framework proposed by the Group of Thirty. OTC contracts should be encouraged to migrate to trade on a nationally regulated exchange with centralized clearing and settlement systems, similar in character to those of the futures and equity option exchange markets. The regulation of the contracts that remain OTC-traded should be subject to supervision by a national regulator with jurisdiction to promulgate rules and standards regarding sound risk management practices, including those needed to manage counterparty credit risk and collateral requirements, uniform close-out practices, trade confirmation and reporting standards, and other regulatory and public reporting standards that will need to be established to improve market transparency. For example, OTC dealers may be required to report selected trade information in a Trade Reporting and Compliance Engine (TRACE)-style system, which would be made publicly available. OTC dealers and exchanges should also be required to report information on large exposures and risk

concentrations to a regulatory authority. This could be modeled in much the same way as futures exchanges regularly report qualifying exposures to the Commodities Futures Trading Commission. The reporting system would need to provide information on concentrations in both short and long positions.

Money market mutual funds

Money market mutual funds (MMMFs) have been shown to be a source of systemic risk in this crisis. Two similar models of reform have been suggested. One would place MMMFs under systemic risk regulation, which would provide permanent access to the discount window and establish a fee-based insurance fund to prevent losses to investors. The other approach, offered by the Group of 30, would segment the industry into MMMFs that offer bank-like services and assurances in maintaining a stable net asset value (NAV) at par from MMMFs that that have no explicit or implicit assurances that investors can withdraw funds on demand at par. Those that operate like banks would be required to reorganize as special-purpose banks, coming under all bank regulations and depositor-like protections. But, this last approach will only be viable if there are restrictions on the size of at-risk MMMFs so that they do not evolve into too-big-to-fail institutions.

Regulatory issues

Several issues can be addressed through the regulatory process including, the originate-to-distribute business model, executive compensation in banks, fair-value accounting, credit rating agency reform and counter-cyclical capital policies.

The originate-to-distribute business model

One of the most important factors driving this financial crisis has been the decline in value, liquidity and underlying collateral performance of a wide swath of previously highly rated asset backed securities. In 2008, over 221,000 rated tranches of private-label asset-backed securitizations were downgraded. This has resulted in a widespread loss of confidence in agency credit ratings for securitized assets, and bank and investor write-downs on their holdings of these assets.

Many of these previously highly rated securities were never traded in secondary markets, and were subject to little or no public disclosure about the characteristics and ongoing performance of underlying collateral. Financial incentives for short-term revenue recognition appear to have driven the creation of large volumes of highly-rated securitization product, with insufficient attention to due diligence, and insufficient recognition of the risks being transferred to investors. Moreover, some aspects of our regulatory framework may have encouraged banks and other institutional investors in the belief that a highly-rated security is, *per se*, of minimal risk.

Today, in a variety of policy-making groups around the world, there is consideration of ways to correct the incentives that led to the failure of the originate-to-distribute model. One area of focus relates to disclosure. For example, rated securitization tranches could be subject to a requirement for disclosure, in a readily accessible format on the ratings-agency websites, of detailed loan-level characteristics and regular performance reports. Over the long term, liquidity and confidence might be improved if secondary market prices and volumes of asset backed securities were reported on some type of system analogous to the Financial Industry Regulatory Authority's Trade Reporting and Compliance Engine that now captures such data on corporate bonds.

Again over the longer term, a more sustainable originate-to-distribute model might result if originators were required to retain "skin-in-the-game" by holding some form of explicit exposure to the assets sold. This idea has been endorsed by the Group of 30 and is being actively explored by the European Commission. Some in the United States have noted that there are implementation challenges of this idea, such as whether we can or should prevent issuers from hedging their exposure to their retained interests. Acknowledging these issues and correcting the problems in the originate-to distribute-model is very important, and some form of "skin-in-the-game" requirement that goes beyond the past practices of the industry should continue to be explored.

Executive compensation in banks

An important area for reform includes the broad area of correcting or offsetting financial incentives for short-term revenue recognition. There has been much discussion of how to ensure financial firms' compensation systems do not excessively reward a short-term focus at the expense of longer term risks. I would note that in the Federal Deposit Insurance Act, Congress gave the banking agencies the explicit authority to define and regulate safe-and-sound compensation practices for insured banks and thrifts. Such regulation would be a potentially powerful tool but one that should be used judiciously to avoid unintended consequences.

Fair-value accounting

Another broad area where inappropriate financial incentives may need to be addressed is in regard to the recognition of potentially volatile non-cash income or expense items. For example, many problematic exposures may have been driven in part by the ability to recognize mark-to-model gains on OTC derivatives or other illiquid financial instruments. To the extent such incentives drove some institutions to hold concentrations of illiquid and volatile exposures, they should be a concern for the safety-and-soundness of individual institutions. Moreover, such practices can make the system as a whole more subject to boom and bust. Regulators should consider taking steps to limit such practices in the future, perhaps by explicit quantitative limits on the extent

such gains could be included in regulatory capital or by incrementally higher regulatory capital requirements when exposures exceed specified concentration limits.

For the immediate present, we are faced with a situation where an institution confronted with even a single dollar of credit loss on its available-for-sale and held-to-maturity securities, must write down the security to fair value, which includes not only recognizing the credit loss, but also the liquidity discount. We have expressed our support for the idea that FASB should consider allowing institutions facing an other-than-temporary impairment (OTTI) loss to recognize the credit loss in earnings but not the liquidity discount. We are pleased that the Financial Accounting Standards Board this week has issued a proposal that would move in this direction.

Credit rating agency reform

The FDIC generally agrees with the Group of 30 recommendation that regulatory policies with regard to Nationally Recognized Securities Rating Organizations (NRSROs) and the use their ratings should be reformed. Regulated entities should do an independent evaluation of credit risk products in which they are investing. NRSROs should evaluate the risk of potential losses from the full range of potential risk factors, including liquidity and price volatility. Regulators should examine the incentives imbedded in the current business models of NRSROs. For example, an important strand of work within the Basel Committee on Banking Supervision that I have supported for some time relates to the creation of operational standards for the use of ratings-based

capital requirements. We need to be sure that in the future, our capital requirements do not incent banks to rely blindly on favorable agency credit ratings. Preconditions for the use of ratings-based capital requirements should ensure investors and regulators have ready access to the loan level data underlying the securities, and that an appropriate level of due diligence has been performed.

Counter-cyclical capital policies

At present, regulatory capital standards do not explicitly consider the stage of the economic cycle in which financial institutions are operating. As institutions seek to improve returns on equity, there is often an incentive to reduce capital and increase leverage when economic conditions are favorable and earnings are strong. However, when a downturn inevitably occurs and losses arising from credit and market risk exposures increase, these institutions' capital ratios may fall to levels that no longer appropriately support their risk profiles.

Therefore, it is important for regulators to institute counter-cyclical capital policies. For example, financial institutions could be required to limit dividends in profitable times to build capital above regulatory minimums or build some type of regulatory capital buffer to cover estimated through-the-cycle credit losses in excess of those reflected in their loan loss allowances under current accounting standards. Through the Basel Committee on Banking Supervision, we are working to strengthen capital to raise its resilience to future episodes of economic and financial stress. Furthermore, we

strongly encourage the accounting standard-setters to revise the existing accounting model for loan losses to better reflect the economics of lending activity and enable lenders to recognize credit impairment earlier in the credit cycle.

Conclusion

The current financial crisis demonstrates the need for changes in the supervision and resolution of financial institutions, especially those that are systemically important to the financial system. The choices facing Congress in this task are complex, made more so by the fact that we are trying to address problems while the whirlwind of economic problems continues to engulf us. While the need for some reforms is obvious, such as a legal framework for resolving systemically important institutions, others are less clear and we would encourage a thoughtful, deliberative approach. 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 institutions -- especially those that pose a systemic risk to the financial system.

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