DEPUTY SECRETARY OF THE TREASURY NEAL S. WOLIN
WRITTEN TESTIMONY BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

"Enhanced Oversight after the Financial Crisis: The Wall Street Reform Act at One Year."

July 21, 2011

Chairman Johnson, Ranking Member Shelby, and members of the Committee, I appreciate the opportunity to appear today and discuss the important work that has been done to rebuild and strengthen our financial system over the past year. As this hearing commemorates, one year ago today the President signed into law a comprehensive set of reforms to the financial system, reforms which are essential to making our economy stronger and more resilient.

Those reforms were enacted in the wake of the most devastating financial crisis since the Great Depression.

In the depths of the crisis, the economy lost an average of 800,000 jobs per month. American families saw $5 trillion of household wealth erased in the last three months of 2008. Credit was frozen. Financial markets were barely functioning.

The Administration and its predecessors put in place a comprehensive strategy to repair the financial system. As a result of that strategy, the U.S. financial system today is stronger, more stable, and better able to fuel growth and create jobs.

Many of the weakest parts of the system—the firms that took the most risk—no longer exist or have been significantly restructured. Of the 15 largest financial institutions in the United States before the crisis, only nine remain as independent entities.

Those that survived did so because they were able to raise capital from private investors. The 19 firms that were put through the stress tests have together increased common equity by more than $300 billion since 2008.

The average level of common equity to risk weighted assets across these institutions is now 10 percent, much higher than before the crisis. And the average level of total leverage in these institutions has fallen substantially – from $16 of assets for every dollar of common equity to $11.

These firms are now funded more conservatively, so that they are much less vulnerable to a loss of liquidity during a future downturn. Debt maturing in one year or less at these institutions, as a share of total liabilities, has declined dramatically to roughly 40 percent of the pre-crisis level.

Assets in the "shadow banking system" are roughly half the level seen in 2007. Funding through tri-party repurchase agreements has fallen 40 percent from its peak in 2007, and asset-backed commercial paper outstanding—which was often used to fund leveraged off-balance sheet vehicles—is a third of where it was in 2007.

Finally, the vast majority of large financial companies that received government support have repaid it—at a positive return to taxpayers. Just two years ago, hundreds of billions in losses were projected on investments in banks. But to date, these investments have returned a total of $10 billion dollars.

These accomplishments were crucial to ending the crisis and providing a basis for growth. But in order to protect our economy and create the conditions for long-term prosperity, we needed to complement this set of changes with comprehensive reform of the financial system. Without reform, any progress our economy made would lack a stable foundation.

As the crisis made clear, prior to the enactment of Dodd-Frank the financial system we had lacked such a foundation, and was weak and susceptible to crisis. The prior system had all too many gaps. Too often it allowed firms to choose their regulators. The prior system did not provide adequate buffers against shock and stress. It did not provide adequate consumer protection. It favored short-term gains for individual firms over the stability and growth of the economy as a whole. And when the system began to fall apart, taxpayers were forced to save it.

We had no choice but to build a better system.

That's why we proposed, Congress passed, and the President signed into law a sweeping set of reforms.

Core Elements of the Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act made important and fundamental changes to the structure of the U.S. financial system to strengthen safeguards for consumers and investors and to provide better tools for limiting risk in the major financial institutions and the financial markets. The core elements of the law were designed to build a stronger, more resilient financial system, less vulnerable to crisis, more efficient in allocating financial resources, and less susceptible to fraud and abuse.

These reforms were responsive to the many weaknesses that together nearly brought our financial system to collapse. They include:

- **Tougher constraints on excessive risk-taking and leverage across the financial system.** To lower the risk of failure of large financial institutions and reduce the damage to the broader economy of such failures, Dodd-Frank provided authority for regulators to impose more conservative limits on risk that could threaten the stability of the financial system.

- **Stronger consumer protection**. Dodd-Frank created the Consumer Financial Protection Bureau (CFPB) to concentrate authority and accountability for consumer protection in a single federal agency, with the ability to enforce protections on banks as well as other types of firms involved in the business of consumer finance.

- **Comprehensive oversight of derivatives**. Dodd-Frank created a new regulatory framework for the over-the-counter derivatives market to increase oversight, transparency, and stability in this previously unregulated area.

- **Transparency and market integrity**. Dodd-Frank included a number of measures that increase disclosure and transparency of financial markets, including new reporting rules for hedge funds, trade repositories to collect information on derivatives markets and improved disclosures on asset-backed securities.

- **Orderly liquidation authority**. Dodd Frank created a new orderly liquidation authority to break up and wind down a failing financial firm in a manner that protects taxpayers and the economy.

- **Accountability for stability and oversight across the financial system**. Dodd-Frank established the Financial Stability Oversight Council (FSOC) to coordinate across agencies in monitoring risks and emerging threats to U.S. financial stability, and the Office of Financial Research (OFR) to improve data quality and facilitate access to and analysis of data for the Council and its member agencies.

Financial Stability Oversight Council

The Dodd-Frank Act created the Financial Stability Oversight Council to, among other things, coordinate across agencies, foster joint accountability for the stability of the financial system, identify and monitor risks to U.S. financial stability, respond to emerging threats in the system and promote market discipline. The Dodd-Frank Act also provides the Council with a leading role in several important regulatory decisions, including determining which nonbank financial companies will be subject to consolidated supervision by the Federal Reserve and enhanced prudential standards, and which financial market utilities will be subject to new risk management standards.

The Council has made significant progress in the year since Dodd-Frank was signed into law. Since enactment, the Council has: (1) built its basic organizational framework; (2) laid the groundwork for the designation of nonbank financial companies and financial market utilities; (3) initiated monitoring for potential risks to U.S. financial stability; (4) carried out the explicit statutory requirements of the Council, including the completion of several studies, progress towards rulemakings, and expected near-term release of its annual report; and (5) served as a forum for discussion and coordination among the agencies implementing Dodd-Frank.

Identification of and monitoring threats to financial stability is a cornerstone of the Council's mandate. FSOC principals and their deputies have been actively engaged in the identification and monitoring of current domestic and global risks, such as the European sovereign debt crisis.

At the FSOC's meeting earlier this week, members discussed their first annual report, which details this monitoring process. As required by statute, the report will: outline the activities of the Council, including any designations or recommendations made with respect to activities that could threaten financial stability; detail significant financial market and regulatory developments, including insurance and accounting regulations and standards; and, describe potential emerging threats to the financial stability of the United States. The report will also include, as required by statute, recommendations to enhance the integrity, efficiency, competitiveness, and stability of the United States financial markets; promote market discipline; and maintain investor confidence. I expect that the report will be released in coming days.

At the meeting, the FSOC also approved a final rule regarding the procedures for designation of financial market utilities (FMU). An FMU designated by the FSOC as systemically important would be subject to the heightened prudential and supervisory provisions of Title VIII of Dodd-Frank. This final rule follows the Council's issuance of an Advanced Notice of Proposed Rulemaking (ANPR) in November of 2010 and a Notice of Proposed Rulemaking (NPR) in March 2011. The Council solicited and reviewed public comment to inform the rule, and provided a transparent process by which interested parties could engage in the rulemaking process.

In addition, the FSOC released its statutorily required study evaluating the potential effect of imposition of haircuts on fully secured creditors of a financial company under the new Title II orderly liquidation authority (OLA). The report concludes that the combination of the OLA and the new prudential supervision of the largest, most interconnected firms under Title I, can be used to address the goals of market discipline and taxpayer protection effectively without the need for secured creditor haircuts.

The FSOC is also actively engaged in of the establishment of effective criteria and procedures for nonbank designations. The Council issued an ANPR in October 2010 and an NPR in January 2010. The FSOC received significant input from interested parties in this rulemaking process in an effort to develop a consistent approach that incorporates both quantitative and qualitative criteria. The Council plans to provide additional guidance regarding the criteria for designations. The guidance will include specific metrics that will help provide clarity on the FSOC's evaluation of firms for potential designation, and will outline both the quantitative and qualitative elements of the analytical framework to be used. The designation process will employ the judgment of the council's members based on a comprehensive understanding of a firm's risks. I anticipate that this proposed guidance will be issued for public comment in the near future.

Office of Financial Research

Dodd-Frank established the Office of Financial Research to improve the quality of financial data available to policymakers and the public, and to facilitate more robust and sophisticated analysis of the financial system.

The search for an OFR Director is ongoing and a high priority for the Administration. The Administration is evaluating candidates based on a combination of strong analytical ability, knowledge about financial markets, management experience, and communication skills. In the interim, Richard Berner, who has been hired as a Counselor to the Treasury Secretary, is leading our efforts to stand-up the office.

The OFR is making progress in the establishment of its research team and network, which will include academics from across the country and in a variety of disciplines. Leading academics and quantitative finance experts are lending their experience and knowledge to help establish the OFR's research operation, including its structure, agenda, and fellowship programs. They also are working on and guiding specific research projects, including those that will support the FSOC's monitoring of risks to the financial system.

We project that by the end of September, the OFR will have about 60 full-time employees. Treasury is committed to providing this implementation team with needed support and guidance, and I, along with other senior Treasury officials, meet with the team weekly to make sure priorities are identified, progress is measured and that the stand-up of the OFR is well-executed.

As the OFR continues to recruit additional highly-qualified individuals to lead and support its work, currently staff are already working with regulators and industry to standardize financial reporting. The OFR's first step in this direction has been to promote the establishment of a legal entity identifier (LEI) system. This public-private initiative, which was launched in November 2010, will create a global standard for the identification of parties to financial transactions. Such a standard will improve the abilities of regulators and firms to manage counterparty risk, assure the integrity of business practices, and lower processing costs for financial transactions.

Over the past few months, the OFR has made great strides in gaining private sector support and global consensus around its LEI initiative. This month, a global coalition of market participants and their members published recommendations for how to best adopt the LEI. U.S. regulators are also working with their international counterparts to develop a consistent approach for the adoption of the LEI. And just earlier this week, the Financial Stability Board released a public statement affirming its support for efforts by financial regulators and industry to establish an LEI, and agreeing to arrange a workshop this fall to discuss the issues that will need to be addressed and on how best to coordinate next steps forward.

In addition to these efforts, OFR staff is supporting the work of the FSOC. This includes providing data and analysis to help develop the analytical framework for FSOC's evaluation of nonbank financial companies for designation and its annual report. The OFR is also working with FSOC member agencies to fulfill data-related requirements from Dodd-Frank. Additionally, the OFR is working with regulators to catalogue the data they already collect to ensure the OFR relies on existing data whenever possible. The OFR will help government get the most out of existing data by facilitating sharing among agencies.

Consumer Financial Protection Bureau

While the FSOC and OFR are designed to help monitor and address risk in the broader financial system, the Consumer Financial Protection Bureau was created to address a specific gap in our regulatory structure—the need for a single agency dedicated to consumer protection.

Before the President signed the Dodd-Frank Wall Street Reform and Consumer Protection Act, consumer financial protection had not been the primary focus of any federal agency, and no agency had effective tools to set the rules for and oversee the whole market. The consumer agency was created to increase government accountability and efficiency by consolidating consumer financial protection authorities that had existed across seven different federal agencies into one. The CFPB will work to make sure that consumers have the information they need to understand the terms of their agreements with financial companies. It will also work to make regulations and guidance as clear and streamlined as possible in order to ease the burden on providers of consumer financial products and services.

In addition to attracting extremely qualified staff from industry, the private sector, and academia, the Bureau has developed an organizational design that will provide the infrastructure needed to meet its responsibilities in the months and years ahead. Key divisions within this structure include:

- consumer engagement and education – to provide, through a variety of initiatives and methods, information to consumers that will allow them to make the decisions that are best for them;
- supervision, fair lending and enforcement – to ensure compliance with federal consumer financial laws by supervising market participants and bringing enforcement actions when appropriate;
- research, markets, and regulations – to understand consumer financial markets and consumer behavior and to evaluate whether there is a need for regulation and the costs and benefits of potential or existing regulations; and
- external affairs – to ensure that the CFPB maintains robust dialogue with various stakeholders that have an interest in its work in order to promote understanding, transparency, and accountability.

The CFPB has received favorable recognition of its stand-up efforts. Notably, the Inspectors General of the Federal Reserve Board and the Department of the Treasury recently issued a strongly positive joint review of the CFPB's stand-up efforts. The report noted that the CFPB identified and documented implementation activities critical to its functions and necessary to address Dodd-Frank requirements. The report found that the CFPB developed and implemented appropriate plans for the transfer occurring today, and that the CFPB communicated this planning and implementation to stakeholders and other consumer regulatory agencies.

Today, the Bureau takes over federal consumer financial supervision of our nation's 111 largest depository institutions and their affiliates. The CFPB supervision program is charged with finding, mitigating, and remedying risks to consumers. Importantly, the CFPB's examination process will strive for transparency, efficiency, and fairness. The Bureau will communicate with institutions throughout its examination cycle, meet with management to discuss findings and conclusions prior to finalizing an exam report, and share aggregate exam findings, including industry guidance, in quarterly public reports

In May, the CFPB launched the Know Before You Owe project, an effort to combine two federally required mortgage disclosures into a single, simpler form that makes the costs and risks of the loan clear and allows consumers to comparison shop for the best offer. The CFPB began testing two alternate prototype forms that are designed to be given to consumers who have just applied for a mortgage loan. This testing—which will continue in the coming months and involve one-on-one interviews with consumers, lenders, and brokers—will precede and inform the CFPB's formal rulemaking process. The CFPB also has posted the prototypes on its website with an interactive tool to gather public input about the designs.

Under the leadership of Holly Petraeus, a longtime advocate for military families, the CFPB has worked hard to get an early start on helping servicemembers navigate the unique circumstances that affect their finances. Under Holly's leadership, the CFPB has entered into an agreement with the Judge Advocate Generals of all the armed services regarding the protection of servicemembers from financial abuse.

The CFPB has begun second stage testing of a consumer response center. Initially, the consumer response center will assist those with credit card complaints. Over the course of the next year, the Bureau will add more products to the consumer response system. As the CFPB builds its infrastructure, the Bureau will work in coordination with the prudential regulators to address other complaints.

The CFPB released two reports this week, which address issues central to consumer protection, meeting the congressional deadlines set by the Wall Street Reform and Consumer Protection Act. The first study examines the variations between the credit scores sold to creditors and those sold to consumers by certain consumer reporting agencies. The second report focuses on how a consumer's remittance history could be used to enhance her credit score, the impediments to using a consumer's remittance history in this way, and recommendations on ways to maximize transparency and disclosure to consumers of exchange rates used for remittance transfers.

This week, President Obama has nominated Richard Cordray to be the first Director of the CFPB. Mr. Cordray is currently the Chief of Enforcement at the CFPB. Previously, he served as Attorney General of Ohio and earned a reputation as one of America's strongest advocates for the interests of consumers. Prior to his tenure as Ohio's Attorney General, Mr. Cordray developed significant experience in finance and the law while serving as Treasurer and Solicitor General of Ohio, and serving in both the Clinton and Bush Justice Departments. Richard Cordray is an outstanding public servant whose career has centered on fighting for middle class families, and we hope that the Senate will move expeditiously to confirm him.

Challenges Ahead

We face a number of challenges as we move forward to complete reform of our financial system.

- We must continue to move forward, quickly but carefully, to implement the law. Continued progress is crucial to giving financial institutions and markets the clarity they need to do business effectively and help our economy grow. At the same time, we will continue to prioritize quality over speed, and we will take the time we need to get it right.

- We must make sure our efforts are coordinated. Without coordination, we risk the formation of gaps like those that contributed to the crisis. Coordination will help prevent regulatory arbitrage, and it will also help provide market participants with clarity and consistency. The better job we do of making sure regulations fit together when areas of finance overlap, the easier it will be for everyone to understand them. The Secretary of the Treasury, as Chair of the Financial Stability Oversight Council, believes that coordination among regulators is a top priority.

- We must take care to recognize important distinctions in our financial system. A key objective of reform is to regulate institutions in a manner appropriate to the risks that they pose to the system. A small bank, for example, cannot and should not have to comply with the same set of rules as a large financial firm, and as we implement reform, we will continue to avoid a one-size-fits-all approach.

- We must continue to improve the quality of regulation as we implement Dodd-Frank. In January, President Obama issued an Executive Order directing executive agencies to streamline and simplify regulations, seeking to ensure cost-effective, evidence-based regulations that are compatible with economic growth, job creation, and competitiveness. And this month, the President issued a second Executive Order encouraging each independent regulatory agency to develop a plan under which the agency will periodically review its existing significant regulations to determine whether any such regulations should be modified, streamlined, expanded, or repealed so as to make the agency's regulatory program more effective or less burdensome in achieving the regulatory objectives. The implementation of comprehensive reform provides financial regulators with a tremendous opportunity. We should therefore work to remove rules that overlap or conflict, ones that are outmoded in today’s financial system, and ones that do not make sense in the context of the new law.

- We must continue to work closely with our international partners to create a level playing field and avoid a race to the bottom. Strong international cooperation, with the U.S. playing a leadership role will be central to the success of global reform. In particular, we will continue to promote international consistency in areas such as OTC derivatives, and financial institutions’ liquidity, leverage, and capital. We need a high set of global standards, so that risk cannot simply shift to other markets.

- We must make sure that regulators have the funding they need to do their jobs. Cutting funding for regulators, especially at a time when they are charged with putting in place an historic and essential set of reforms, will undermine their ability to protect the financial system and our broader economy. Funding for the regulators is an absolutely necessary insurance policy on our financial health, because the costliest system of all is one that is prone to collapse. We cannot afford not to provide regulators with the resources they need.

Conclusion

A year ago, in the wake of a catastrophic financial crisis, Congress passed and the President enacted a law to reform our financial system. These reforms were an obligation, not a choice. Without them, we could not build the financial system we need—a financial system with the stability and the resilience necessary to support our economy and protect it in times of stress. Our country needs a financial system that is stronger and more robust, and also promotes innovation, fosters growth, and creates jobs—a system that channels capital effectively to businesses and to consumers.

We do not have to choose between stability and growth. Rather, they are both key ingredients to a healthy economy, and our careful, balanced approach to implementation recognizes the importance of both. But if we are to succeed in creating a system with both strength and dynamism, we must continue to move forward. We must complete our implementation of the Dodd-Frank Act.