Statement before the Senate Committee on Banking, Housing, and Urban Affairs
On Establishing a Framework for Systemic Risk Regulation

For Best Results: Simplify

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Chairman Dodd, Ranking Member Shelby, and Members of the Committee thank-you for the opportunity to testify today.

No doubt, the American people expect significant remedial action in the aftermath of the extraordinary government support to financial institutions over the past year. Indeed, this is probably a generational moment in which this Congress will shape the financial landscape for decades to come. At the outset, however, we must remember that greater discipline does not always follow from more intricate oversight.

The Problem

In fact, complexity has been the bane of our financial system for decades and cannot be the solution going forward. We have created an intricate, multifaceted terrain of opportunities through our financial regulations, tax codes, and accounting rules. There are multiple federal regulators and state alternatives. Different jurisdictions offer varied enticements in terms of favorable legal structure and tax treatment. And the tax code ranges across region and over time.

Financial firms have burrowed into every nook and cranny. This has required the effort of legal specialists, accounting experts, and financial engineers. As a result, the balance sheets of large firms have been splintered into a collection of special purpose vehicles, and securities have been issued with no other purpose than extracting as much value as possible from the Basel II Supervisory Accord.

This complexity introduces three fundamental problems in monitoring behavior.

First, supervisors are at a decided disadvantage in understanding risk taking and compliance for a firm that might involve dozens of jurisdictions, hundreds of legal entities, and thousands of contractual relationships. Firms know this and tailor individual instruments to a small slice of its clientele to take advantage of tax and accounting rules. Its balance sheet might respond quickly to advances in finance and legal interpretations. And the same risks might be booked in different ways across affiliates, let alone across different institutions, with evident consequences for capital requirements. Indeed, the reliance of self-regulation inherent in the Basel II supervisory agreement can be seen as an official admission of defeat: a large complex financial institution cannot be understood from outside.

But if an institution is so difficult to understand from the outside, how can we expect market discipline to be effective? The second cost of complexity is that the outside discipline of credit counterparties and equity owners is blunted. Creditors are more likely to look to the firm's reputation or a stamp from a rating agency rather than the underlying collateral provided by the financial contract. Equity owners are more likely to defer to senior management, opening the way to compensation abuses and twisting incentives to emphasize short-term gains. In this regard, it is probably not an accident that financial firms tend not to be targets for hostile takeovers—their balance sheets are impenetrable from the outside.

Third, the problems in understanding the workings of a complicated firm are not limited to those on the outside. A complicated firm is also difficult to manage. Employers will find it more difficult to monitor employees, especially when staff on the ground have highly specialized expertise in finance, law, and accounting. Simply put, employees who are difficult to monitor cannot be expected to promote the long-term interests of their workplace. What follows are abuses in matching loans and investments to the appropriate customer and, in some cases, outright fraud.

Note the irony. A firm's effort to take advantage of government induced distortions by becoming more complicated and by making its instruments more complex lessens the owner's ability to monitor management and management's ability to monitor workers. Market discipline breaks down.

The Simple Solution

Sometimes the answer to a complicated problem is simple, as Alexander found with the Gordian Knot. Cut through the existing tangle of financial regulation. Consolidate federal financial regulators and assume state responsibilities. Simplify accounting rules and the tax code. Make the components of financial firms modular so that the whole can be split up into basic parts at a time of stress, advice that may have eased resolution of AIG's financial products division. With simple rules that define lines more sharply, our federal regulators will find enforcement much easier. If firms are more transparent, official supervision will be reinforced by the newfound discipline exercised by shareholders and creditors. And with fewer places for self-interest to hide, employees will be more accountable in their efforts to preserve the longer-term value of their firms.

I recognize that a Congress pressed for results might be reluctant to enact radical simplification. The consolidation of multiple agencies and the shift of power away from states to a single federal entity seem daunting. Even harder might be the necessary reduction in the variety of corporate charters and the pruning of the tax code and accounting rules. Indeed, this is an invitation to jurisdictional warfare, as each regulator jockeys for viability. But a more established set of rules for the resolution of large firms, simplification of regulations generally, and consolidation of supervision specifically should be the aspiration of this Congress. I shall argue that a well-designed financial stability supervisor can be a means to that end.

A Distinct Choice

The Treasury recently laid out a new foundation for financial regulation. It envisions granting the Federal Reserve new authority to supervise all firms that could pose a threat to financial stability, even those that do not own banks. I disagree. Such powers should not be given to an existing agency, especially not the nation's central bank. Rather, the Congress should form a committee of existing supervisors, headed by an independent director, appointed by the President, and confirmed by the Senate. The director should have a budget for staff and real powers to compel cooperation among the constituent agencies and reporting from unregulated entities, if necessary.

Why shouldn't an existing agency head the committee? From the Congress's perspective, an agency is a black box that is difficult to monitor, filled with technicians given multiple tools directed toward multiple goals. The more complicated is its mission, the more opportunities those technicians will have to trade off among those goals. For example, consider the plight, admittedly abstract, of an agency told to enforce a capital standard and to foster lending. At a downturn in the business cycle, it might be tempted to allow overly optimistic asset valuations so as to prevent balance-sheet constraints from slackening lending. Perhaps, this compromise might be consistent with the implied wishes of the Congress. But perhaps not. Because an agency, especially focused on technical matters, tends to be opaque, it will be difficult for its legislative creators to hold it accountable.

There are adverse implications of burdening an agency, any agency, with multiple goals. First, the public will be confused about what goes on behind the curtain. This makes it less likely that the agency will find widespread support for its core responsibilities or anyone who identifies with its mission. Second, and a bit more inside the Beltway, it will be hard to fill the slots at agencies where the job description calls for multiple technical talents and competing demands on time. Third, key relationships of an agency with the Congress and other regulators can become hostage to peripheral turf fights. From my own experience, the atmosphere at Fed hearings was especially charged in 2004 and 2005 in both chambers. Some members and staff thought that Chairman Greenspan was dragging his feet on consumer disclosure regulation. My point is not that they were wrong in criticizing the Chairman. Rather, my point is that time set aside in legislation to discuss the plans and objectives of the Fed for monetary policy was chewed up on other topics. As a result, Fed credibility was impaired for reasons other than the performance of the economy.

The Fed Exception

I have thus far offered general objections to giving financial stability responsibilities to an existing agency. I believe that there are even more compelling reasons that those responsibilities should not be given to the Fed. Please recognize that I worked in the

Federal Reserve System for a quarter-century and that I hold its staff in high esteem. They are knowledgeable, competent, and committed to their mission. But any group of people in an independent agency assigned too many goals will be pulled in too many directions. And there is one goal given to the Fed that should not be jeopardized: the pursuit of maximum employment and stable prices. Indeed, that goal is so pivotal to the nation's interest that the Congress should be thinking of narrowing, not broadening, the Fed's focus.

Three other concerns should give you pause before signing on to the Treasury's blueprint of a new role for the Fed.

First, as compared to other agencies, the Fed has significant macroeconomic policy and lending tools. If it failed in its role as systemic supervisor to identify the originator of the next financial crisis, might it be more likely to use those tools beyond what is necessary for the achievement of its core monetary policy responsibility?

Second, you might hear that the expertise gained in assessing financial stability will help to inform the Fed's pursuit of macro policy goals. That would work in principal. In practice, I believe that there are precious few instances of that favorable feedback, despite the Fed's involvement in bank supervision since its inception. But I stand willing to be proved wrong. The Fed's monetary policy deliberations over the years are extremely well documented in thousands of pages of minutes and transcripts. Anyone making the case for beneficial spillovers should be asked to produce numerous relevant excerpts from that treasure trove. I do not think they will be able to do so because I do not think those examples exist.

Third, the gift of extraordinary powers to an agency merits forthright accountability from that agency. It is up to you to determine whether the Fed has been sufficiently accountable during this recent episode. In that regard, however, I would note an inconsistency in the Treasury blueprint. It wants to give the Fed new powers regarding financial stability. At the same time, it seeks to circumscribe the one unusual power that the Fed has exercised over the past year by requiring the Treasury Secretary to sign off in advance of lending in unusual and exigent circumstances. Which best describes the true Fed—empowerment or limitation?

An Alternative

My strong preference, absent radical simplification, is that the supervision of financial stability be delegated to a committee of existing financial supervisors. Those constituent agencies have the specific expertise to understand our complicated financial world. At the head should be someone appointed by the President and confirmed by the Senate. He or she should have a budget to staff a secretariat deemed suitable. And that agency should have independent powers. It should be able to compel the information sharing among the constituent supervisors and the reporting of information, if necessary, from unregulated entities. The constituent agencies should regularly be directed to draft reports in their areas of expertise for consideration by the full committee and transmittal to the Congress. This would include twice-a-year reports on macroeconomic stability from the Fed, appraisals of the health of the banking system from the FDIC, and assessments on the resilience of financial market infrastructure from the SEC and the CFTC.

Why does the committee head need to be appointed in that capacity and have unique powers? The committee head needs the heft associated with an independent selection. Without power, the committee would devolve to a debating society that spends the first five years of its existence negotiating memoranda of understanding on the sharing of information.

Think about this analogy. In the run-up to the financial crisis, every single large complex financial institution had a senior risk management committee. In most cases, all those committees managed to do was to allow the build-up of large risks. Now the U.S. government has a significant ownership stake in many of them. The few exceptional, successful firms were the ones that gave the risk managers real powers to control positioning. Why should the federal government settle for a toothless authority?

A Longer-term Vision

The real benefits of a financial stability committee would come if the Congress were forward-looking in writing its mandate. The committee could be a vehicle to foster the achievement over time of robust rules for the resolution of private firms, simplification of the financial system, and consolidation of financial agencies.

Let me take each in turn.

Resolution. At a time of crisis, we resort to the injection of public funds into private firms because we are afraid of letting market forces play out. Each major firm should negotiate a "living will" with its regulator each year. That living will should detail how the firm should be disassembled in the event of bankruptcy. It should list the segments of the firm that are systemically important and provide contractual mechanisms to ring-fence them. The secretariat of the financial stability committee should assess those plans to make sure what looked good on paper could be applied *in extremis*. Also, the secretariat can recommend industry initiatives to narrow over time the ambit of firm-specific systemically important activities.

Periodically, the head of the committee should report to the Congress—in closed session if necessary—about the status of resolution plans. This would be the opportunity to identify areas for legislation, if necessary, to give the government more effective resolution powers.

Simplification. It will not take long for anyone tasked with working through the innermost machinations of major financial firms to conclude that our system is hopelessly complicated. The head of the financial stability committee should report annually on opportunities to hack away at that underbrush, be it agency regulations, accounting rules, or the tax code. The ambition of the new agency to simplify financial rules, across industries and products, should be as wide as the net cast for threats to financial stability. Those opportunities are both in federal and state legislation and agency regulation. On a flow basis, new legislation should be scored, much as is already done for budgetary impact, for the effects on the complexity of the financial system.

Consolidation. The low hanging fruit of simplification will most likely come in consolidating federal agencies and state responsibilities. An independent agency head should have the perspective and stature to identify such opportunities that can be the basis of future legislation. That is, part of the job of the committee's chair should be explaining how the committee should get smaller over time.

Conclusion

Facilitating resolution, simplifying rules, and consolidating regulators will go a long way in making financial firms more transparent. This will aid in enforcing remaining regulation, disciplining credit decisions, and monitoring employees. It is also patently fairer. Being bigger or more complicated or having better lobbyists will not covey an advantage in a world of clear lines, strict enforcement, and no exceptions. We have lived in a world or fine print and sharp lawyers and look where that got us. We are ready for change.

I would prefer that this change come quickly, but others might see this as too abrupt. If significant simplification does not come now, a strong independent financial stability committee could provide immediate protection and the promise of identifying areas for future progress along the lines I have laid out.