Testimony Concerning
Regulation of Systemic Risk

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Introduction

Chairman Dodd, Ranking Member Shelby, and Members of the Committee: I am pleased to have the opportunity to testify concerning the regulation of systemic risk in the U.S. financial industry.[1]

We have learned many lessons from the recent financial crisis and events of last fall, central among them being the need to identify, monitor, and reduce the possibility that a sudden shock will lead to a market seizure or cascade of failures that puts the entire financial system at risk.

In turning those lessons into reforms, the following should guide us:

First, there are two different kinds of "systemic risk": (1) the risk of sudden, near-term systemic seizures or cascading failures and (2) the longer-term risk that our system will unintentionally favor large systemically important institutions over smaller, more nimble competitors, reducing the system's ability to innovate and adapt to change. We must be very careful that our efforts to protect the system from near-term systemic seizures do not inadvertently result in a long-term systemic imbalance.

Second, there are two different kinds of "systemic risk regulation": (1) the traditional oversight, regulation, market transparency and enforcement provided by primary regulators that helps keep systemic risk from developing in the first place and (2) the new "macro-prudential" regulation designed to identify and minimize systemic risk if it does.

Third, we must be cognizant of both kinds of regulation if we are to minimize both kinds of "systemic risk." I believe the best way to achieve this balance is to:

[1] My testimony is own my own behalf, as Chairman of the SEC. The commission has not voted on this testimony.

- address structural imbalances that facilitate the development of systemic risk by closing gaps in regulation, improving transparency and strengthening enforcement; and

- establish a workable, macro-prudential regulatory framework consisting of a single Systemic Risk Regulator ("SRR") with clear authority and accountability and a Financial Stability Oversight Council ("Council") that can identify risks across the system, write rules to minimize systemic risk and help ensure that future regulatory gaps – and arbitrage opportunities – are minimized or avoided.

Throughout this process, however, we must remain vigilant that our efforts to minimize "sudden systemic risk" do not inadvertently create new structural imbalances that undermine the long-term vibrancy of our capital markets.

Addressing Structural Imbalances through Traditional Oversight

Much of the debate surrounding "systemic risk" and financial regulatory reform has focused on new "macro-prudential" oversight and regulation. This debate has focused on whether we need a systemic risk regulator to identify and minimize systemic risk and how to resolve large interconnected institutions whose failure might affect the health of others or the system. The debate also has focused on whether it is possible to declare our readiness to "resolve" systemically important institutions without unintentionally facilitating their growth and systemic importance.

Before turning to those issues, it is important that we not forget the role that traditional oversight, regulation and market transparency play in reducing systemic risk. This is the traditional "block and tackle" oversight and regulation that is vital to ensuring that systemic risks do not develop in the first place.

Filling Regulatory Gaps

One central mechanism for reducing systemic risk is to ensure the same rules apply to the same or similar products and participants. Our global capital markets are incredibly fast and competitive: financial participants are competing with each other not just for ideas and talent but also with respect to "micro-seconds" and basis points. In such an environment, if financial participants realize they can achieve the same economic ends with fewer costs by flocking to a regulatory gap, they will do so quickly, often with size and leverage.

We have seen this time and again, most recently with over-the-counter derivatives, instruments through which major institutions engage in enormous, virtually unregulated trading in synthetic versions of other, often regulated financial products. We can do much to reduce systemic risk if we close these gaps and ensure that similar products are regulated similarly.

Improving Market Transparency

In conjunction with filling regulatory gaps, market transparency can help to decrease systemic risk. We have seen tremendous growth in financial products and vehicles that work exactly like other products and vehicles, but with little or no transparency.

For example, there are "dark pools" in which securities are traded that work like traditional markets without the oversight or information flow. Also, enormous risk resides in "off-balance sheet" vehicles hidden from investors and other market participants who likely would have allocated capital more efficiently – and away from these risks – had the risks been fully disclosed.

Transparency reduces systemic risk in several ways. It gives regulators and investors better information about markets, products and participants. It also helps regulators leverage market behavior to minimize the need for larger interventions.

Where market participants are given sufficient information about assets, liabilities and risks, they, following their risk-reward analyses, could themselves allocate capital away from risk or demand higher returns for it. This in turn would help to reduce systemic risk before it develops. In this sense, the new "macro-prudential" systemic risk regulation (set forth later in this testimony) can be seen as an important tool for identifying and reducing systemic risk, but not a first or only line of defense.

I support the Administration's efforts to fill regulatory gaps and improve market transparency, particularly with respect to over-the-counter derivatives and hedge funds, and I believe they will go a long way toward reducing systemic risk.

Active Enforcement

It is important to note the role active regulation and enforcement plays in changing behavior and reducing systemic risks.

Though we need vibrant capital markets and financial innovation to meet our country's changing needs, we have learned there are two sides to financial innovation. At their best, our markets are incredible machines capable of taking "ordinary" investments and savings and transforming them into new, highly-useful products – turning today's thrift into tomorrow's stable wealth. At their worst, the self-interests of financial engineers seeking short-term profit can lead to ever more complex and costly products designed less to serve investors' needs than to generate fees.

Throughout this crisis we have seen how traditional processes evolved into questionable business practices, that, when combined with leverage and global markets, created extensive systemic risk. A counterbalance to this is active enforcement that serves as a ready reminder of (1) what the rules are and (2) why we need them to protect consumers, investors and taxpayers – and indeed the system itself.

Macro-Prudential Oversight: The Need for a Systemic Risk Regulator and Financial Stability Oversight Council

Although I believe in the critical role that traditional oversight, regulation, enforcement and market transparency must play in reducing systemic risk, they alone are not sufficient.

Functional regulation alone has shown several key shortcomings. First, information – and thinking – can remain "siloed." Functional regulators typically look at particular financial participants or vehicles even as individual financial products flow through them all, often resulting in their seeing only small pieces of the broader financial landscape.

Second, because financial actors can use different vehicles or jurisdictions from which to engage in the same activity, actors can sometimes "choose" their regulatory framework. This choice can sometimes result in regulatory competition – and a race to the bottom among competing regulators and jurisdictions, lowering standards and increasing systemic risk.

Third, functional regulators have a set of statutory powers and a legal framework designed for their particular types of financial products or entities. Even if a regulator could extend its existing powers over other entities not typically within its jurisdiction, these legal frameworks are not easily transferrable either to other entities or other types of risk.

Given these shortcomings, I agree with the Administration on the need to establish a regulatory framework for macro-prudential oversight.

Within that framework, I believe a hybrid approach consisting of a single systemic risk regulator and a powerful council is most appropriate. Such an approach would provide the best structure to ensure clear accountability for systemic risk, enable a strong, nimble response should circumstances arise and maintain the broad and differing perspectives needed to best identify developing risks and minimize unintended consequences.

A Systemic Risk Regulator

Given the (1) speed, size and complexity of our global capital markets; (2) large role a relatively small number of major financial intermediaries play in that system; and (3) extent of government interventions needed to address the recent turmoil, I agree there needs to be a government entity responsible for monitoring our entire financial system for system-wide risks, with the tools to forestall emergencies. I believe this role could be performed by the Federal Reserve or a new entity specifically designed for this task.

This "systemic risk regulator" should have access to information across the financial markets and, in addition to the individual functional regulators, serve as a second set of eyes upon those institutions whose failure might put the system at risk. It should have ready access to information about institutions that might pose a risk to the system, including holding company liquidity and risk exposures; monitor whether institutions are maintaining capital levels required by the Council; and have clear delegated authority to respond quickly in extraordinary circumstances.

In addition, an SRR should be required to report to the Council on its supervisory programs and the risks and trends it identifies at the institutions it supervises.

Financial Stability Oversight Council

Further, I agree with the Administration and FDIC Chairman Bair that this SRR must be combined with a newly-created Council. I believe, however, that any Council must be strengthened beyond the framework set forth in the Administration's "White Paper."

This Council should have the tools needed to identify emerging risks, be able to establish rules for leverage and risk-based capital for systemically-important institutions; and be empowered to serve as a ready mechanism for identifying emerging risks and minimizing the regulatory arbitrage that can lead to a regulatory race to the bottom.

To balance the weakness of monitoring systemic risk through the lens of any single regulator, the Council would permit us to assess emerging risks from the vantage of a multi-disciplinary group of financial experts with responsibilities that extend to different types of financial institutions, both large and small. Members could include representatives of the Department of the Treasury, SEC, CFTC, FRB, OCC, and FDIC.

The Council should have authority to identify institutions, practices, and markets that create potential systemic risks and set standards for liquidity, capital and other risk management practices at systemically important institutions. The SRR would then be responsible for implementing these standards.

The Council also should provide a forum for discussing and recommending regulatory standards across markets, helping to identify gaps in the regulatory framework before they morph into larger problems. This hybrid approach can help minimize systemic risk in a number of ways:

- First, a Council would ensure different perspectives to help identify risks that an individual regulator might miss or consider too small to warrant attention. These perspectives would also improve the quality of systemic risk requirements by increasing the likelihood that second-order consequences are considered and flushed out;

- Second, the financial regulators on the Council would have experience regulating different types of institutions (including smaller institutions) so that the Council would be more likely to ensure that risk-based capital and leverage requirements do not unintentionally foster systemic risk. Such a result could occur by giving large, systemically important institutions a competitive advantage over smaller institutions that would permit them to grow even larger and more risky; and

- Third, the Council would include multiple agencies, thereby significantly reducing potential conflicts of interest (e.g., conflicts with other regulatory missions).

The Council also would monitor the development of financial institutions to prevent the creation of institutions that are either "too-big-to-fail" or "too-big-to-succeed." In that regard, I believe that insufficient attention has been paid to the risks posed by institutions whose businesses are so large and diverse that they have become, for all intents and purposes, unmanageable. Given the potential daily oversight role of the SRR, it would likely be less capable of identifying and avoiding these risks impartially. Accordingly, the Council framework is vital to ensure that our desire to minimize short-term systemic risk does not inadvertently undermine our system's long-term health.

Coordination of Council/SRR with Primary Regulators

In most times, I would expect the Council and SRR to work with and through primary regulators of systemically important institutions. The primary regulators understand the markets, products and activities of their regulated entities. The SRR, however, can provide a second layer of review over the activities, capital and risk management procedures of systemically important institutions as a backstop to ensure that no red flags are missed.

If differences arise between the SRR and the primary regulator regarding the capital or risk management standards of systemically important institutions, I strongly believe that the higher (more conservative) standard should govern. The systemic risk regulatory structure should serve as a "brake" on a systemically important institution's riskiness; it should never be an "accelerator."

In emergency situations, the SRR may need to overrule a primary regulator (for example, to impose higher standards or to stop or limit potentially risky activities). However, to ensure that authority is checked and decisions are not arbitrary, the Council should be where general policy is set, and only then to implement a more rigorous policy than that of a primary regulator. This will reduce the ability of any single regulator to "compete" with other regulators by lowering standards, driving a race to the bottom.

Unwinding Systemic Risk – A Third Option

I agree with the Administration, the FDIC, and others that the government needs a credible resolution mechanism for unwinding systemically important institutions.

Currently, banks and broker-dealers are subject to well-established resolution processes under the Federal Deposit Insurance Corporation Improvement Act and the Securities Investor Protection Act, respectively. No corresponding resolution process exists, however, for the holding companies of systemically significant financial institutions.

In times of crisis when a systemically important institution may be teetering on the brink of failure, policymakers are left in the difficult position of choosing between two highly unappealing options: (1) providing government assistance to a failing institution (or an acquirer of a failing institution), thereby allowing markets to continue functioning but potentially fostering more irresponsible risk-taking in the future; or (2) not providing government assistance but running the risk of market collapses and greater costs in the future.

Markets recognize this Hobson's choice and can actually fuel more systemic risk by "pricing in" the possibility of a government backstop of large-interconnected institutions. This can give them an advantage over their smaller competitors and make them even larger and more interconnected.

A credible resolution regime can help address these risks by giving policy makers a third option: a controlled unwinding of the institution over time. Structured correctly, such a regime could force market participants to realize the full costs of their decisions and help reduce the "too-big-to-fail" dilemma. Structured poorly, such a regime could strengthen market expectations of government support, as a result fueling "too-big-to-fail" risks.

Avoidance of conflicts of interest in this regime will be paramount. Different regulators with different missions may have different priorities. For example, both customer accounts with broker-dealers and depositor accounts in banks must be protected and should not be used to cross-subsidize other efforts. A healthy consultation process with a regulated entity's primary regulator will provide needed institutional knowledge to ensure that potential conflicts such as this are minimized.

Conclusion

To better ensure that system-wide risks will be identified and minimized without inadvertently creating larger risk down the road, I recommend that Congress establish a strong Financial Stability Oversight Council, comprised of the primary regulators.

The Council should have responsibility for identifying systemically significant institutions and systemic risks, making recommendations about and implementing actions to address those risks, promoting effective information flow, setting liquidity and capital standards, and ensuring key supervisors apply those standards appropriately.

The various primary regulators offer broad perspectives across markets that represent a wide range of institutions and investors. This array of perspectives is essential to build a foundation for the development of a robust regulatory framework better designed to withstand future periods of market or economic volatility and help restore investors' confidence in our Nation's markets. I believe a structure such as this provides the best balance for reducing sudden systemic risk without undermining the competitive and resilient capital markets needed over the long term.

Thank you again for the opportunity to present my views. I look forward to working with the Committee on any financial reform efforts it may undertake, and I would be pleased to answer any questions.