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Financial Regulatory Reform
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Chairwoman Maloney, Vice Chairman Schumer, I am pleased to appear before the Joint Economic Committee today. The House and the Senate are both making rapid progress toward the goal of comprehensive financial reform, and I appreciate the opportunity to talk about why that reform effort is so essential for the health of our economy and what, in our view, is necessary to make the effort successful.

The United States is in the process of recovering from the worst financial and economic crisis in generations. After an extended and painful contraction, we saw solid annualized GDP growth of 3.5 percent last quarter. We expect continued growth in the fourth quarter and ahead in 2010.

But as we press forward towards recovery, there is still much work to do – not only to ensure that many more Americans see the tangible benefits of recovery, but also to help ensure that Americans are never again forced to suffer the consequences of a preventable economic collapse.

In the years leading up to the crisis, our financial regulatory regime permitted an excessive build-up of risk, both inside and outside the traditional banking system. The shock absorbers critical to preserving stability – capital, margin, and liquidity cushions in particular – were inadequate. Outdated, ineffective regulation left our system too weak to withstand the failure of major financial institutions.

Firms took huge risks with borrowed funds and little of their own capital at stake. They funded long-term, illiquid assets with cheap, short-term debt. This risky behavior migrated from the regulated and partially regulated parts of our financial system to the almost entirely unregulated parts, making it difficult for us to control or even gauge its dimensions.

The result was a financial system vulnerable to bubbles, panic and collapse.

And unfortunately, the regulatory regime that failed so terribly leading up to the financial crisis is precisely the regulatory regime we have today. That is why recovery alone is not enough. To ensure the vitality, the strength and the stability of our economy going forward, we must bring our system of financial regulation into the twenty-first century. We need comprehensive financial reform.

To achieve financial reform, the Administration has advanced a broad set of proposals. We have worked closely – and continue to work closely – with Chairman Frank, Chairman Dodd and members of their respective committees and other important legislators, including many on this Committee, to craft strong financial reform legislation that we hope will be enacted as soon as possible.

Given the range and complexity of the issues with which we are dealing and the critical stage at which our work has now arrived, it is important to step back for a moment and remind ourselves of the central objective of reform – and the key principles that, in the Administration's judgment, are essential to achieving that objective.

The central objective of reform is to establish a safer, more stable financial system that can deliver the benefits of market-driven financial innovation even as it guards against the dangers of market-driven excess. It is to ensure that the financial system functions in a way that creates opportunity and reduces risk. It is to provide stronger protections for consumers, investors, and tax-payers.

In our view, there are at least four key principles that we must follow in order to achieve that objective. These are not meant to be exhaustive. But we do believe they are essential.

First, firms must not be able to escape or avoid regulation by choosing one legal form over another. Firms engaged in the same kind of business, performing the same essential economic functions, must be subject to fundamentally the same regulation and supervision.

Today, bank holding companies are subject to one supervisory regime, thrift holding companies to another, investment bank holding companies to yet another. Without changing its core business, a firm can change – or avoid altogether – regulation at the holding company level simply by switching its legal form.

The fact that investment banks like Bear Stearns or Lehman Brothers or other large firms like AIG could escape meaningful consolidated federal supervision simply by virtue of their legal form should be considered unthinkable from now on. The largest, most interconnected firms must be subject to one uniform, consistent set of standards, regardless of charter.

Similar inconsistencies plague the market for consumer lending. Banks and non-banks operate in the same market and compete for the same customers. But they play with a different rulebook. Non-banks like mortgage brokers, consumer credit companies and payday lenders escape federal supervision almost entirely. The inconsistent regulatory regime sparked a race to the bottom in the mortgage lending market, and the consequences are tragic and well known.

The second principle of reform is that there must be clear regulatory accountability. The principle is particularly important with respect to oversight of the largest, most interconnected firms.

The regulation of the largest, most interconnected firms requires tremendous institutional capacity, clear lines of authority and single-point accountability. This is no place for regulation by council or by committee. The stakes are simply too high to allow diffuse authorities and responsibilities to weaken accountability.

In addition, an essential element of accountability is that rule-writing and enforcement authority must not be divided. Separating rule-writing from enforcement deprives the rule-writer of vital, hands-on information – and gives both the rule-writer and the supervisor an excuse for failure. A rule-writer that is also a supervisor and enforcer, on the other hand, is unmistakably accountable for success – or failure.

Today, responsibility for consumer financial protection is divided among numerous regulators, none of whom regard consumer protection as their top priority. To ensure more responsive and more effective rule writing and enforcement, we have proposed the creation of the Consumer Financial Protection Agency (CFPA). Consolidating the consumer protection authority of the Fed and other prudential regulators, the CFPA would be fully accountable for setting and enforcing rules of the road for the benefit of responsible consumers.

The third principle is that the financial system as a whole must be more capable of absorbing shocks and coping with failures.

One of the most salient lessons of the recent crisis is that financial firms are deeply intertwined, linked by a complex web of contractual and reputational connections. These inter-firm connections allow financial distress to spread contagion across the system. The risk of such contagion means that capital, liquidity and margin requirements must be increased, system-wide – and set with a view to ensuring the stability of the financial system as a whole, not just the solvency of individual institutions.

In addition, there must in the future be a greater focus on the quality of capital, and an effort to design capital requirements that are more forward-looking and reduce pro-cyclicality.
While the buffers need to be increased system-wide, the largest firms should face still higher prudential requirements. They should be forced to internalize the cost of the risks they impose on the financial system, and to strengthen their ability to withstand shocks and downturns.

While strengthening prudential standards for firms is one element of making the system as a whole more resilient and risk-absorptive, it is not alone sufficient.

To strengthen the system overall, the Administration has called for measures to strengthen financial markets and the financial market infrastructure. For example, we have proposed to strengthen supervision and regulation of critical payment, clearing, and settlement systems and to regulate comprehensively the derivatives markets.

We should never again face a situation – so devastating in the case of AIG – where a virtually unregulated major player in the derivatives market can impose risks on the entire system.

The fourth and final principle is that no financial institution should be considered "Too Big to Fail."

During the recent crisis, in order to preserve the stability of the financial system, protect the savings of Americans and prevent a far more devastating economic collapse, the government was forced to provide financial support to individual institutions *in extremis*. Those interventions were necessary, but they must not – and do not – set a precedent.

Institutions and investors must be responsible for their decisions. No financial system can operate efficiently if financial institutions and investors assume that the government will protect them from the consequences of failure. And as the President said two months ago in New York, "Those on Wall Street cannot resume taking risks without regard for consequences, and expect that next time, American taxpayers will be there to break their fall."

Part of the answer is simply making the financial system more resilient – as just discussed – by strengthening supervision, eliminating loopholes, building up capital and liquidity buffers, and increasing transparency in key markets. In most circumstances, those precautions will be enough. And for that reason, bankruptcy will remain the dominant means of dealing with the failure of a non-bank financial firm.

But as Lehman's collapse showed quite starkly last year, the U.S. government does not have the tools to respond effectively when failure of large, non-bank financial institutions truly threatens the stability of the system at large.

That is why the Administration has proposed that the government have the authority – as we have today for banks and thrifts – to break apart or unwind major non-bank financial firms in an orderly way, imposing pain on shareholders, creditors, and managers, but limiting collateral damage to the system and sparing the taxpayers.

The proposed resolution authority would not authorize the government to provide open-bank assistance to any failing firm. In other words, the authority would facilitate the orderly demise of a failing firm, not ensure its survival.

Moreover, if there are losses to the government in connection with the resolution, the losses will be recouped from the largest financial institutions in proportion to their size. The financial industry – not taxpayers – will be on the hook.

We must be sure we have the necessary tools to cushion the broader financial system against potential shocks, in times of severe stress. Otherwise, in a financial panic, credit to our economy, to small businesses and homeowners could grind to a halt. To make sure the tools we have are effective but narrowly tailored to achieving financial stability goals, we have proposed to modify the emergency authorities of the FDIC and the Federal Reserve. Their authorities should be subject to appropriate checks and balances and should be available only to protect the financial system as a whole, not individual institutions.

Should new financial crises occur, despite our best efforts to prevent them, these tools are essential to preserve the government's ability to respond in an effective, responsible way.

Let me close by saying this: In today's markets, capital moves at speeds unimaginable when our current regulatory framework was created. Financial instruments that were mere novelties a few decades ago have grown to play a critical role in our financial system. Whatever statutory framework we erect today will, undoubtedly, encounter new, unfamiliar institutions, instruments and markets.

But if we put in place a set of financial reforms that prioritizes consistency, accountability, and resilience, and responsibility; if we fight to close gaps, eliminate loopholes, empower regulators and hold them accountable, raise standards, and give the government the tools it needs to manage crises while ensuring that no one is insulated from the consequences of their actions; if we do those things, we will be able to say that we have met our obligation to the next generation.

Finally, let me thank again the members of this committee. And let me thank again those members of the House Financial Services Committee and the Senate Banking Committee for the good work that you are all doing to advance this important legislation.

Thank you.