

Prepared statement of
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Before the House Committee on Financial Services

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Thank you, Chairman Frank for the opportunity to appear before the Committee to discuss the critical issues of establishing a systemic risk regulator and a resolution authority.

As a former chairman of the Securities and Exchange Commission, and currently as an advisor to Getco LLC, The Carlyle Group, and Goldman Sachs, I hope I can share with you important considerations and perspectives to inform your efforts.

I want to begin by thanking you for your attention to these issues, as the need for regulatory reform is as great as it was even during the worst days of the recent financial crisis. Though the appetite for regulatory reform seems to move in inverse relationship to market performance, the financial markets are no less risky and regulatory gaps remain. I am concerned that public investors may well be convinced, because of the relative market calm of the last few months, that all is well in our regulatory system. But all is not well. And I am glad you are showing leadership in addressing these issues.

Your success will be determined by how well you affirm the principles of effective financial regulation -- principles relating to transparency and regulatory independence, the proper oversight of leverage and risk-taking, the nurturing of strong enforcement, early intervention, and the imposition of market discipline.

One of the key questions before this committee is how to authorize and hold accountable a systemic risk regulator -- and who should provide this function.

I would like to suggest that the more critical question is whether any regulator or groups of regulators can have the same impact as well as a resolution authority created explicitly to impose discipline on those with the most power to influence the level of risk-taking: the holders of both equity and debt of the institutions which may be "too big to fail."

And so in my view, the discussion over the proper authority to oversee and regulate systemic risk, while critical, is secondary to the powers given to a resolution authority to impose discipline through the process of sending these institutions to their demise and thus severely

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impacting holders of the debt and equity. To give a simple analogy, it does not matter who serves as the cop on the beat if there are no courts of law to send lawbreakers to jail.

So with my time today, I would like to only briefly discuss my preferences regarding who should serve as the systemic risk regulator, and focus more squarely on the matter of a resolution authority.

What is the right structure for a systemic risk regulator?

I believe strongly that a systemic risk regulator must serve as an early warning system, drawing on a broad array of sources of information, and with the power to direct appropriate regulatory agencies to implement actions. I am not opposed to this function and am agnostic about who should lead such an agency and perform this function.

I would caution against making the Federal Reserve the systemic risk regulator in its present structure. The Fed has too many conflicts to do this job effectively. Defending the “safety and soundness” of financial institutions and managing monetary policy creates inevitable and compromising conflicts with the kind of vigilant and independent oversight a systemic risk regulator requires. If, however, the Fed is deemed to be the best available place for this role, I would urge the Congress to remove from the Fed some of its responsibilities – especially those of bank oversight. Let the Fed, and every other regulatory agency, focus on one major responsibility.

Why we need a resolution authority, and what that entails

In many respects, the surest way to cause investors, lenders, and management to focus on risk is not to warn them about risk, but to give them every conceivable way to discover risk and tell them what will happen if they don't pay attention. Right now, because of the permissive policies summarized by the phrase “too big to fail,” market participants lack that guidance and foreknowledge, and assume that any institution of a certain size simply won't be allowed to fail. This is a dangerous and costly assumption, and only encourages more recklessness.

Some have suggested that the solution to this problem is to cap the size of any financial institution at some arbitrary amount of asset size. But the nature of today's financial markets makes it impossible to restrict any institution from becoming too big – any nation which sets a cap on the size of its financial institutions will merely see its banks become subordinate to those from other nations. Therefore if you want to address the challenge of “too big to fail”, you must address not the “too big” part but the “fail” part – how to manage the process of failure. The problem we have had isn't that institutions were too big – it was that there was no uniform way to let them fail without causing an absolute market meltdown.

In the case of Lehman, the Fed and the Treasury were faced with a choice none of us would want to face – and a choice none of us want to ever face again.

We can deal with this by establishing a resolution authority charged with closing out failed institutions without, if possible, further government assistance. Those holding debt and equities in a failing institution would be losers in this process, and the resolution authority would have vast powers to restructure institutions which pose system-wide risk. Mandatory conversion would always be on the table, and not all creditors would be treated equally.

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A resolution authority which has the power to do just about anything to put a failing bank in order or close it down in an orderly way without major government "bailing" -- such as terminate contracts, sell assets, cancel debt, cancel equity, and refer management for civil penalties for taking excessive risk even after multiple warnings -- would bring a clarifying force to the daily decisions of management, customers, creditors, and investors.

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I would expect that they would become a good deal more careful -- having foreknowledge of their potential rights and responsibilities should the resolution authority be activated. By having a personal stake in potential failure, they would see the advantage to greater transparency and developing more knowledge of individual institutions, and this market discovery may well do the work of many outside systemic risk regulators.

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The need for transparency

Of course, if your goal is to incentivize market discovery, you will also want to give market participants greater access to information about the institutions in which they invest. This calls for a greater focus on transparency, which members of this Committee will not be surprised to know I feel has been de-emphasized in recent years. Events of the past year call for every regulatory action to be held to a higher standard of transparency and accountability.

In fact, I would argue that in addition to the creation of a resolution authority, greater transparency is essential to effective systemic risk regulation -- whether through the actions of investors or of regulators.

I want to emphasize in particular the importance of fair value accounting for major financial institutions engaging in significant amounts of risk-taking and leverage. Such accounting gives investors a true sense of the value of an asset in all market conditions -- not just those conditions favored by asset holders. It is my view that a more vigorous application of fair-value standards would have helped identify some of the major causes of the market bubble that we recently witnessed -- weak underwriting standards, unsound risk management practices,

increasingly complex and opaque financial products, and consequent excessive leverage. Vigorous use of fair-value standards might not have identified all these emerging problems, but with enough transparency and an investor public incentivized to discover these problems before they blew up, I believe we would not have had the system-wide crises we did.

Clearly, a series of other rules – banning the use of off-balance-sheet vehicles, to name just one – would move more information about major financial institutions into the public sphere, making it possible for market participants to price risk appropriately and for a systemic risk regulator to demand fresh infusions of liquidity or higher margin requirements if needed.

I would much prefer that a systemic risk regulator be so effective that a resolution authority would be unnecessary. But sadly, we know that always preventing failure is impossible. It is therefore your job to make failure possible.

I want to thank you again for your attention to these critical issues, and urge you to accelerate your efforts.