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Statement by

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## Introduction

Thank you Chairman Frank, Ranking Member Bachus, and other members of the Committee. I appreciate the opportunity to testify about the critical topic of financial regulatory reform.

Over the past 18 months, we have faced the most severe global financial crisis in generations. Some of the world's largest financial institutions have failed. Equity and real estate prices have fallen sharply, eroding the value of our savings. The supply of credit has tightened dramatically. Confidence in the overall financial system, in the protections it is supposed to afford for investors and consumers, has eroded. These financial pressures have intensified the recession now underway around the world.

And as in any financial crisis, the damage falls on Main Street. It affects the vulnerable. It affects those who were conservative and responsible, not just those who took too much risk.

Our system is wrapped today in extraordinary complexity, but beneath all that, financial systems serve an essential and basic function. Financial institutions and markets transform the earnings and savings of American workers into the loans that finance a home, a new car or a college education. They exist to allocate savings and investment to their most productive uses.

Our financial system does this better than any other financial system in the world, but our system failed in basic fundamental ways. The system proved too unstable and fragile, subject to significant crises every few years, periodic booms in real estate markets and in credit, followed by busts and contraction. Innovation and complexity overwhelmed the checks and balances in the system. Compensation practices rewarded short-term profits over long-term return. We saw huge gains in increased access to credit for large parts of the American economy, but those gains were overshadowed by pervasive failures in consumer protection, leaving many Americans with obligations they did not understand and could not sustain. The huge apparent returns to financial activity attracted fraud on a dramatic scale. Large amounts of leverage and risk were created both within and outside the regulated part of the financial system.

These failures have caused a great loss of confidence in the basic fabric of our financial system, a system that over time has been a tremendous asset for the American economy.

To address this will require comprehensive reform. Not modest repairs at the margin, but new rules of the game. The new rules must be simpler and more effectively enforced and produce a more stable system, that protects consumers and investors, that rewards innovation and that is able to adapt and evolve with changes in the financial market.

On February 25, after meeting with the banking and financial services leadership from Congress, President Obama directed his economic team to develop recommendations for financial regulatory reform and to begin the process of working with the Congress on new legislation. The Treasury Department has been working with the President's Working Group on Financial Markets (PWG) to develop a comprehensive plan of reform. This effort has been and will be guided by principles the President set forth earlier this year and in his speech as a candidate at Cooper Union in March 2008.

Financial institutions and markets that are critical to the functioning of the financial system and that could pose serious risks to the stability of the financial system need to be subject to strong oversight by the government. Our financial system and the major centralized markets must be strong and resilient enough to withstand very severe shocks and the failure of one or more large institutions. We need much stronger standards for openness, transparency, and plain, common sense language throughout the financial system. And we need strong and uniform supervision for all financial products marketed to consumers and investors, and tough enforcement of the rules to ensure full accountability for those who violate the public trust.

Financial products and institutions should be regulated for the economic function they provide and the risks they present, not the legal form they take. We can't allow institutions to cherry pick among competing regulators, and shift risk to where it faces the lowest standards and constraints.

And we need to recognize that risk does not respect national borders. We need to prevent national competition to reduce standards and encourage a race to higher standards. Markets are global and high standards at home need to be complemented by strong international standards enforced more evenly and fairly. These are global markets and challenges. Building on these principles, we want to work with Congress to put in place fundamental reforms that create a stronger, more stable system, with much stronger protections for consumers and investors, and a more streamlined, consolidated, and simple oversight framework.

I want to begin that process today by focusing on proposals that are essential to creating a more stable system, with stronger tools to prevent and manage future crises. In this context, my objective is to concentrate on the substance of the reform agenda, rather than the complex and sensitive questions of who should be responsible for what.
Over the next few weeks we will outline proposals in the areas of consumer and investor protection and for reform of regulatory oversight arrangements.

We start with systemic risk, not just because of its obvious importance to our future economic performance, but also because these issues require more cooperation globally, and they will be at the center of the agenda at the upcoming Leaders' Summit of the G-20 in London on April 2.

These proposals reflect a range of complex and consequential policy choices. They will require careful work and drafting. It is important that we get this right. We recognize there will be many alternative models put forth to achieve the objective we all share of creating a more stable system. And we look forward to working with the Federal

Reserve, with the agencies that make up the President's Working Group on Financial Markets, and with the Congress on a package of reforms that we can all support.

**The Crisis and Its Fundamental Causes**

The current crisis had many causes.

Two decades of sustained economic growth bred widespread complacency among financial intermediaries and investors, lowering borrowing costs and weakening lending standards.

A global boom in savings resulted in large flows of capital into the United States and other markets, pushing down long-term interest rates and pushing up asset prices. The rising market hid Ponzi schemes and other flagrant abuses that should have been detected and eliminated.

In that environment, institutions and investors looked for higher returns by taking on greater exposure to the risk of infrequent but severe losses.

A long period of home price appreciation encouraged borrowers, lenders, and investors to make choices that could only succeed if home prices continued to appreciate. We had a system under which firms encouraged people to take unwise risks on complicated products, with ruinous results for them and for our financial system.

Market discipline failed to constrain dangerous levels of risk-taking throughout the financial system. New financial products were created to meet demand from investors, and the complexity outmatched the risk-management capabilities of even the most sophisticated financial institutions. Financial activity migrated outside the banking system, relying on the assumption that liquidity would always be available.

Regulated institutions held too little capital relative to the risks to which they were exposed. And the combined effects of the requirements for capital, reserves and liquidity amplified rather than dampened financial cycles. This worked to intensify the boom and magnify the bust.

Supervision and regulation failed to prevent these problems. There were failures where regulation was extensive and failures where it was absent.

Regulators were aware that a large share of loans made by banks and other lenders were being originated for distribution to investors through securitizations, but they did not identify the risks caused by explosive growth in complex products based on these products.

Investment banks, large insurance companies, finance companies, and the GSEs were subject to only limited oversight on a consolidated basis, despite the fact that many of those companies owned federally insured depository institutions or had other access to explicit or implicit forms of support from the government. Federal law allowed many institutions to choose among regulatory regimes for consolidated supervision and, not surprisingly, they avoided the stronger regulatory authority applicable to bank holding companies. Those companies and others were highly leveraged or used short-term borrowing to buy long-term assets, yet lacked strong federal prudential regulation and routine access to central bank liquidity.

And while supervision and regulation failed to constrain the build up of leverage and risk, the United States came into this crisis without adequate tools to manage it effectively. Until the Housing and Economic Recovery Act and the Emergency Economic Stabilization Act were passed in the summer and fall of 2008, the executive branch had effectively no ability to provide the capital or guarantees necessary to contain the damage caused by the crisis.

And as I discussed before this committee on Tuesday, U.S. law left regulators without good options for managing failures of systemically important non-bank financial institutions.

Regulation of a financial system as complex and dynamic as our system is inherently difficult and challenging. But that difficulty has been compounded by a U.S. regulatory structure that is unnecessarily complex and fragmented. The complexity has sometimes resulted in a failure to assign clear responsibility for achievement of some public policy objectives, notably for financial stability.

**Toward a More Stable and Resilient Financial System**

Our comprehensive framework for regulatory reform will cover four broad areas: systemic risk, consumer and investor protection, eliminating gaps in our regulatory structure; and international coordination.

In the coming weeks, I will present detailed frameworks for each of these areas. Today, I will discuss in greater detail the need to create tools to identify and mitigate systemic risk, including tools to protect the financial system from the failure of systemically important financial institutions.

Second, weaknesses in our consumer and investor protections harm individuals, undermine trust in our financial system, and can contribute to systemic crises that shake the very foundations of our financial system. The choice of what home mortgage to get or how to save for retirement are some of the most important financial decisions that households make. It is crucial that when households make choices we have clear rules of the road that prevent manipulation and abuse. We must restore integrity to our financial system and strengthen these protections. Consumer and investor protection is a critical component of the President’s regulatory reform plan. We are developing a strong, comprehensive plan for consumer and investor regulation to simplify financial decisions for households and to protect people from unfair and deceptive practices.

We must end the practice of allowing banks and other financial companies to choose their regulator simply by changing their charters; regulators must choose who to regulate. Moreover, our regulatory system must be comprehensive and eliminate gaps in coverage. Our regulatory structure must assign clear regulatory authority, resources, and accountability for each of the key regulatory functions. We must not let turf wars or concerns about the shape of organizational charts prevent us from establishing a substantive system of regulation that meets the needs of the American people.
To match the increasing global markets, we must ensure that global standards for financial regulation are consistent with the high standards we will be implementing in the United States.

The Financial Stability Forum (FSF) has played an essential role in the effort, working with the world's standard - setting bodies to study the underlying causes of the crises and address these weaknesses. Much progress is being made to enhance sound regulation, strengthen transparency, and reinforce international collaboration.

We have begun to work with international colleagues to reform and strengthen the FSF so that it can play a more effective role alongside the original Bretton Woods institutions in strengthening the financial system. We have already gotten agreement to expand the membership to include all G-20 countries, giving it a stronger mandate for promoting more robust standards consistent with the principles above, and working with the IMF and the World Bank to monitor the implementation of those standards.

In addition, we will launch a new, initiative to address prudential supervision, tax havens, and money laundering issues in weakly regulated jurisdictions. President Obama will underscore in London on April 2 at the Leaders' Summit the imperative of raising standards across the globe and encouraging a race to the top rather than a race to the bottom.

**Reducing Systemic Risk**

The crisis of the past 18 months has exposed critical gaps and weaknesses in our regulatory system. As risks built up, internal risk management systems, rating agencies and regulators simply did not understand or address critical behaviors until they had already resulted in catastrophic losses.

This crisis has made clear that certain large, interconnected firms and markets need to be under a more consistent, and more conservative regulatory regime. These standards cannot simply address the soundness of individual institutions, but must also ensure the stability of the system itself. We need to strengthen our system of prudential supervision across the financial sector. We must require that firms build up capital during good economic times so that they have a more robust protection against losses in down times – and can continue to lend to America's households and businesses big and small. We need to examine our accounting rules to see whether, consistent with investor protection, we can require firms to build up loan loss reserves that look forward and account for losses in downturns.

In addition, regulators must issue standards for executive compensation practices across all financial firms. These guidelines should encourage prudent risk-taking, incent a focus on long-term performance of the firm rather than short-term profits, and should not otherwise create incentives that overwhelm risk management frameworks.
The key elements of our plan to address systemic risk are:

First, we need to establish a single entity with responsibility for systemic stability over the major institutions and critical payment and settlement systems and activities.

Second, we need to establish and enforce substantially more conservative capital requirements for institutions that pose potential risk to the stability of the financial system, that are designed to dampen rather than amplify financial cycles.

Third, we should require that leveraged private investment funds with assets under management over a certain threshold register with the SEC to provide greater capacity for protecting investors and market integrity.

Fourth, we should establish a comprehensive framework of oversight, protections and disclosure for the OTC derivatives market, moving the standardized parts of those markets to central clearinghouse, and encouraging further use of exchange-traded instruments.

Fifth, the SEC should develop strong requirements for money market funds to reduce the risk of rapid withdrawals of funds that could pose greater risks to market functioning.
And sixth, we need to establish a stronger resolution mechanism that gives the government tools to protect the financial system and the broader economy from the potential failure of large complex financial institutions.

**Systemically Important Financial Firms and Markets**

To ensure appropriate focus and accountability for financial stability we need to establish a single entity with responsibility for consolidated supervision of systemically important firms and for systemically important payment and settlement systems and activities.
We can no longer allow major financial institutions to choose among consolidated supervision regimes and regulators or to avoid consolidated supervision entirely. That means we must create higher standards for all systemically important financial firms regardless of whether they own a depository institution, to account for the risk that the distress or failure of such a firm could impose on the financial system and the economy. We will work with Congress to enact legislation that defines the characteristics of covered firms, sets objectives and principles for their oversight, and assigns responsibility for regulating these firms.

In identifying systemically important firms, we believe that the characteristics to be considered should include: the financial system's interdependence with the firm, the firm's size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding, and the firm's the importance of the firm as a source of credit for households, businesses, and governments and as a source of liquidity for the financial system.

In general, the design and degree of conservatism of the prudential requirements applicable to such firms should take into account the inherent inability of regulators to predict future outcomes.

Capital requirements for these firms must be sufficiently robust to be effective farther into the tails of potential outcomes than capital requirements for other financial firms. And they must be less pro-cyclical, requiring firms to build up substantial capital buffers in good economic times so that they can avoid deleveraging in cyclical downturns.

The single systemic regulator will also need to impose liquidity, counterparty, and credit risk management requirements that are more stringent than for other financial firms. For instance, supervisors should apply more demanding liquidity constraints; and require that these firms are able to aggregate counterparty risk exposures on an enterprise basis within a matter of hours.

The regulator of these entities will also need a prompt, corrective action regime that would allow the regulator to force protective actions as regulatory capital levels decline, similar to that of the FDIC with respect to its covered agencies.

**Payment and Settlement Activities**

Weaknesses in the settlement systems for key funding and risk transfer markets, notably overnight and short-term lending markets (such as those for tri-party repurchase agreements) and OTC derivatives, have been highlighted as a key mechanism that could spread financial distress between institutions and across borders. While some progress was made in the markets for CDS and other OTC derivatives while I was at the New York Fed, federal authority over such arrangements is incomplete and fragmented, and we have been forced to rely heavily on moral suasion to encourage market participants to strengthen these markets.

We need to give a single entity broad and clear authority over systemically important payment and settlement systems and activities. Where such systems or their participants are already federally regulated, the authority of those federal regulators should be preserved and the single entity should consult and coordinate with those regulators.

**Hedge Funds and Other Private Pools of Capital**

U. S. law generally does not require hedge funds or other private pools of capital to register with a federal financial regulator, although some funds that trade commodity derivatives must register with the CFTC and many funds register voluntarily with the SEC. As a result, there are no reliable, comprehensive data available to assess whether such funds individually or collectively pose a threat to financial stability. However, in the wake of the Madoff episode it is clear that, in order to protect investors, we must close gaps and weaknesses in regulation of investment advisors and the funds they manage.

Accordingly, we recommend that all advisers to hedge funds (and other private pools of capital, including private equity funds and venture capital funds) with assets under management over a certain threshold be required to register with the SEC. All such funds advised by an SEC-registered investment adviser should be subject to investor and counterparty disclosure requirements and regulatory reporting requirements. The regulatory reporting requirements for such funds should require reporting, on a confidential basis, information necessary to assess whether the fund or fund family is so large or highly leveraged that it poses a threat to financial stability. The SEC should share the reports that it receives from the funds with the entity responsible for oversight of systemically important firms, which would then determine whether any hedge funds could pose a systemic threat and should be subjected to the prudential standards outlined above.

**Credit Default Swaps and Other OTC Derivatives**

The current financial crisis has been amplified by excessive risk-taking by certain insurance companies and poor counterparty credit risk management by many banks trading Credit Default Swaps (CDS) on asset-backed securities. These complex instruments were poorly understood by counterparties, and the implication that they could threaten the entire financial system or bring down a company of the size and scope of AIG was not identified by regulators, in part because the CDS markets lacked transparency.

Let me be clear: the days when a major insurance company could bet the house on credit default swaps with no one watching and no credible backing to protect the company or taxpayers from losses must end.

In our proposed regulatory system, the government will regulate the markets for credit default swaps and over-the-counter derivatives for the first time.

We will subject all dealers in OTC derivative markets and any other firms whose activities in those markets pose a systemic threat to a strong regulatory and supervisory regime as systemically important firms.

We will force all standardized OTC derivative contracts to be cleared through appropriately designed central counterparties (CCPs). We will also encourage greater use of exchange-traded instruments.

The CCPs will be subject to comprehensive settlement systems supervision and oversight, consistent with the authority outlined above.

We will require that all non-standardized derivatives contracts be reported to trade repositories and be subject to robust standards for documentation and confirmation of trades, netting, collateral and margin practices, and close-out practices.

We will bring unparalleled transparency to the OTC derivatives markets by requiring CCPs and trade repositories to make aggregate data on trading volumes and positions available to the public and make individual counterparty trade and position data available on a confidential basis to federal regulators, including those with responsibilities for market integrity.

Finally, we will strengthen participant eligibility requirements and, where appropriate, introduce disclosure or suitability requirements, and we will require all market participants to meet recordkeeping and reporting requirements.

**Money Market Mutual Funds (MMFs)**

In the wake of Lehman Brothers' bankruptcy, we learned that even one of the most stable and least risky investment vehicles - money market mutual funds - was not safe from the failure of a systemically important institution. These funds are subject to strict regulation by the SEC and are billed as having a stable asset value - a dollar invested will always return the same amount. But when a major prime MMF "broke the buck" - lost money - the event sparked sharp withdrawals across the entire prime MMF industry. Those withdrawals resulted in severe liquidity pressures, not only on prime MMFs but also on financial and non-financial companies that relied significantly on MMFs for funding. The vulnerability of MMFs to breaking the buck and the susceptibility of the entire prime MMF industry to sharp withdrawals in such circumstances remains a significant source of systemic risk.

We believe that the SEC should strengthen the regulatory framework around MMFs in order to reduce the credit and liquidity risk profile of individual MMFs and to make the MMF industry as a whole is less susceptible to runs.

**Resolution Authority**

As I discussed on Tuesday, we must create a resolution regime that provides authority to avoid the disorderly liquidation of any nonbank financial firm whose disorderly liquidation would have serious adverse effects on the financial system or the U.S. economy.

Please note that the draft resolution legislation we have submitted is a first step intended to address a significant void in today's regulatory structure. This mechanism is intended to be a permanent authority and therefore, will also be a critical element of Treasury's broader regulatory reform proposals. As we move forward on those proposals, we will need to align the draft legislation with the broader regulatory reform effort as it develops. At this point, however, I will focus on how the authority and mechanism would work within our current regulatory framework.

We must cover financial institutions that have the potential to pose systemic risks to our economy but that are not currently subject to the resolution authority of the FDIC. This would include bank and thrift holding companies and holding companies that control broker-dealers, insurance companies, and futures commission merchants, or any other financial firm posing substantial risk to our economy.

Before any of the emergency measures specified could be taken, the Secretary of the Treasury, upon the positive recommendations of both the Federal Reserve Board and the FDIC and in consultation with the President, would have to make a triggering determination that (1) the financial institution in question is in danger of becoming insolvent; (2) its insolvency would have serious adverse effects on economic conditions or financial stability in the United States; and (3) taking emergency action as provided for in the law would avoid or mitigate those adverse effects.

The Treasury and the FDIC would decide whether to provide financial assistance to the institution or to put it into conservatorship/receivership. This decision will be informed by the recommendations of the Federal Reserve Board and the appropriate federal regulatory agency (if different from the FDIC). The U.S. government would be permitted to utilize a number of different forms of financial assistance in order to stabilize the institution in question. These include making loans to the financial institution in question, purchasing its obligations or assets, assuming or guaranteeing its liabilities, and purchasing an equity interest in the institution.

This authority is modeled on the resolution authority that the FDIC has under current law with respect to banks and that the Federal Housing Finance Agency has with regard to the GSEs. Here, conservatorships or receiverships aim to minimize the impact of the potential failure of the financial institution on the financial system and consumers as a whole, rather than simply addressing the rights of the institution's creditors as in bankruptcy.

Depending on the circumstances, the FDIC and the Treasury would place the firm into conservatorship with the aim of returning it to private hands or a receivership that would manage the process of winding down the firm. The trustee of the conservatorship or receivership would have broad powers, including to sell or transfer the assets or liabilities of the institution in question, to renegotiate or repudiate the institution's contracts (including with its employees), and to deal with a derivatives book. A conservator would also have the power to fundamentally restructure the institution by, for example, replacing its board of directors and its senior officers. None of these actions would be subject to the approval of the institution's creditors or other stakeholders.

The proposed legislation would create an appropriate mechanism to fund the appropriately limited exercise of the resolution authorities it confers. This could take the form of a mandatory appropriation to the FDIC out of the general fund of the Treasury (subject to all the restrictions on the use of appropriated funds, including apportionments under the Anti-Deficiency Act), and/or through a scheme of assessments, ex ante or ex post, on the financial institutions covered by the legislation. The government would also receive repayment from the redemption of any loans made to the financial institution in question, and from the ultimate sale of any equity interest taken by the government in the institution.  The Deposit Insurance Fund will not be used to fund such assistance.

**Conclusion**

The President has made clear that we will do what is necessary to stabilize the financial system and restore the conditions for economic growth.  Working closely with the Congress, we have moved quickly and with forceful action to help get people back to work and the economy growing again. With your help we are also moving to repair the financial system so that it works for, rather than against, recovery.

Comprehensive regulatory reform is critical to these efforts.   In the coming days and weeks, we will continue to lay out the steps we must take to protect against systemic risk.  We will also lay out a detailed framework for stronger rules to protect consumers and investors against fraud and abuse.

Next week I will join President Obama in London for the G-20 leaders meeting to build support - with the help of other interested nations and strengthened international bodies - for higher global standards for financial regulation.

We are a strong and resilient country.  We came into the current crisis without the authority and tools we needed to contain the damage to the economy from the financial crisis. We are moving to ensure that we are equipped with both in the future, and in the process,  that we modernize our 20th century regulatory system meet 21st century financial challenges.