S. HRG. 111–228

THE ADMINISTRATION'S PROPOSAL TO MODERNIZE THE FINANCIAL REGULATORY SYSTEM

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE ADMINISTRATION'S PROPOSAL TO MODERNIZE THE FINANCIAL REGULATORY SYSTEM

JUNE 18, 2009

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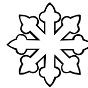

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THE ADMINISTRATION'S PROPOSAL TO MODERNIZE THE FINANCIAL REGULATORY SYSTEM

THURSDAY, JUNE 18, 2009

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 9:34 a.m., in room SH–216, Hart Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order.

Again, I want to welcome my colleagues, welcome the Secretary. We are pleased to have you before us again, Mr. Secretary, this morning. I welcome our audience that is here this morning.

We will proceed in the following manner: I will make some opening remarks. I will ask Senator Shelby as well if he would care to make any opening remarks. And then to move things along, unless any Member here is so compelled, I would like to get right to the Secretary for his comments, then get right to the questioning if we can as well. So that is the manner in which we will proceed, but I thank everyone for making it here this morning. Again, Mr. Secretary, thank you for being with us.

This morning we are going to conduct this hearing on the administration's proposal to modernize the financial regulatory system, and for those of us—I was there yesterday at the White House to hear the President make his presentation, along with many others. So good morning and thank you again for being with us. I would like to welcome the Secretary, who is here to discuss the administration's proposal.

Mr. Secretary, we applaud your leadership on a very complex set of issues intended to restore confidence and stability in our financial system, and I, along with my colleagues, look forward to exploring the details of your plan and working with you and our colleagues here and the other body on this truly historic endeavor.

In my home State of Connecticut and around the Nation, working men and women who did nothing wrong have watched the economy fall through the floor, taking with it their jobs, in many cases their homes, their life savings, and the economic security that has always been the cherished promise of the American middle class. These people, our constituents across the contractor, the

American taxpayer, are hurting. They are very angry and they are worried, and they are wondering who is looking out for them.

I have seen firsthand how hard people work in my State, as I know my colleagues here—and you have, too, Mr. Secretary, what they do to support their families, to build financial security for themselves. I have seen, as well as my colleagues have, how devastating this economic crisis has been for them. And I firmly believe that someone should "have their backs," as the expression goes.

So as we work together to rebuild and reform the regulatory structures whose failures led us to this crisis, I, along with my colleagues here, will continue to insist that improving consumer protection be a first principle and an urgent priority.

I welcome the administration's adoption of this principle, and I am pleased to see it reflected in the plans that we will be discussing this morning.

At the center of this effort will be a new, independent consumer protection agency to protect Americans from poisonous financial products. This is a very simple, common-sense idea. We do not allow toy manufacturers to sell toys that could hurt our children. We do not allow electronic companies to sell defective appliances. Why should a usurious payday loan be treated any differently than we treat an unsafe toy or a malfunctioning toaster? Why should an unscrupulous lender be allowed to dupe a borrower into a loan the lender knows cannot be repaid? There is no excuse for allowing a financial services company to take advantage of American consumers by selling them dangerous financial products. Let us put a cop on the beat so that this spectacular failure of consumer protection at the root of this mess is never repeated again.

We have been engaged in an examination of just what went wrong in the lead-up to this crisis since February of 2007 when experts and regulators from across the spectrum testified before this very Committee that poorly underwritten mortgages would create a tsunami of foreclosures. Those mortgages were securitized and sold around the globe. The market is supposed to distribute risk, but because for years no one was minding the store, these toxic assets served to amplify risk in our system.

Everything associated with these securities—the credit ratings applied to them, the solvency of the institutions holding them, and the creditworthiness of the underlying borrowers—became suspect. And as the financial system tried to pull back from these securities, it took down some of the country's most venerable institutions—firms that had survived world wars, great depressions, down for decades and decades, and wiped out over $6 trillion in household wealth since last fall alone.

Stronger consumer protection I believe would have stopped this crisis before it started. Consumers were sold subprime and exotic loans they could not afford to repay and were, frankly, cheated. They should have been the canaries in the coal mine. But instead of heeding the warnings of many experts, regulators turned a blind eye, and it was regulatory neglect that allowed the crisis to spread to the point where the basic economic security of my constituents and millions more around the country here, including folks who have never seen or heard of mortgage-backed securities, was

threatened by the greed of some bad actors on Wall Street and elsewhere and the failure of our regulatory system.

To rebuild confidence in our financial system, both here at home and around the world, we must reconstruct our regulatory framework to ensure that our financial institutions are properly capitalized, regulated, and supervised. The institutions and products that make up our financial system must act to generate wealth, not destroy it.

In November, I announced five principles which would guide the Banking Committee's efforts in the coming weeks and months.

First and foremost, regulators must be focused and empowered aggressive watchdogs rather than passive enablers of reckless practices.

Second, we have to remove the gaps and overlaps in our regulatory structure that have encouraged charter shopping and a race to the bottom in an effort to win over bank and thrift clients.

Third, we must ensure that any part of our financial system that poses a systemic wide risk is carefully and sensibly supervised. A firm too big to fail is a firm too big to leave unmonitored.

Fourth, we cannot have effective regulation without more transparency. Our economy has suffered from the lack of information about trillion-dollar markets and the migration of risks within them.

And, fifth, our actions must help Americans remain prosperous and competitive in a global marketplace.

These principles will guide my consideration of the plan that you bring to our Committee this morning, Mr. Secretary, and I believe that we can find common ground in a number of the areas contained in your proposal. And I want to thank you again for your leadership on these issues as well as for your willingness to consider different perspectives in forging this plan. I hope you will view this as a continuation of the dialogue that you have had with Members of this Committee, both Democrats and Republicans, as we work together to shape a regulatory framework that will serve our Nation well into the 21st century.

I want to thank all of my colleagues on this Committee as well, by the way, who have demonstrated a strong interest in this issue and are determined to work together. Senator Shelby will obviously give his own opening remarks, but he and I have talked on numerous occasions about how this issue that we will grapple with here as a Committee may be the most important thing this Committee will have done in the last 60 or 70 years or the most important thing any one of us is going to do as a Members of this Committee for years to come—getting this right.

I do not sense on this Committee any great ideological divides. What I do sense is a determination to figure out what works best, to get it right, and to get the job done. So I am really excited about the opportunity that is being posed by the proposal you have put forward and the work in front of us. And I want to urge everyone on our Committee and elsewhere to remember that at the end of the day, at the end of all of this, the success of what we attempt will be measured by its effect on the borrower, on the shareholder, on the investor, the depositor, the consumers, and taxpayers seeking not to attain extravagant wealth but simply to grow a small

business, pay for college, buy a home, and pass on something to their children. That is the American dream, and that is what we are gathered to restore.

Let me just say, while it is not part of my remarks I prepared for this morning, when I pick up the morning newspaper and I read the first headline here, "Fault Lines Emerge as Industry Groups Blast Plan to Create Consumer Agency," what planet are you living on? The very people who created the damn mess are the ones now arguing that consumers ought not to be protected. They are the people who have paid this price. And the idea that you are going to first want to attack the very clients and customers who depend upon you every day is not the place to begin.

And so I am somewhat upset when I see those kinds of remarks when we are trying to look for cooperation and building some common ideas.

With that, I turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

I have said on a number of occasions that reforming our financial regulatory system may be, as Senator Dodd has indicated, the most significant thing many of us will do while serving in the U.S. Senate. We all know how difficult it can be to shepherd even minor bills through the legislative process, let alone anything as significant as financial regulatory reform. We also know equally well that the opportunity to accomplish something of this magnitude can be fleeting, which presents a bit of a conundrum. We certainly want to strike while the iron is hot, but we also want to make the most of the opportunity that has been presented.

The philosopher William James once said, "He who refuses to embrace a unique opportunity loses the prize as surely as if he has failed." I hope that we do not collectively refuse to embrace this unique opportunity because here failure I believe is not an option.

The President has put forward his plan. It deserves our careful consideration. That consideration will involve not only an evaluation of his proposed reforms but, more importantly, a close examination of the facts upon which he based his recommendations. The administration's factual predicate can then be compared with the Committee's findings as soon as we complete our examination of the crisis.

I have said many times this Committee must first clearly identify what went wrong before we even began to consider a response. It is my hope that we can take advantage of some of the work done by the Secretary and others in the administration. It would be helpful if Secretary Geithner could share with Congress any and all documents and information used in their process in their recommendation.

As is the case with all legislative efforts, laws are built around consensus, and consensus is achieved when all parties can agree on either facts or principles. There is one fact upon which I believe we have reached a complete agreement. Our financial regulatory system is antiquated and inadequate. I am not as confident, however, that we have reached agreement on what principles should guide our efforts yet.

As we begin evaluating the President's plan, I want to highlight the key considerations that I believe should guide our process as we move forward.

First, notwithstanding the great difficulties we have recently experienced, private markets still provide the best means for achieving our full economic potential. Risk taking is an essential ingredient in these markets, and while we should improve our ability to manage risk, we cannot simply eliminate risk taking without sacrificing the foundation of our free market system. We must also remember that risk is a two-way street. Those who take risk must be prepared to suffer the losses as well as enjoy the gains. Any reforms we adopt must reduce expectations that some firms are simply too big to fail.

Second, we must establish regulatory mandates that are achievable. This is especially true with respect to the regulation of systemic risk. And while there is wide agreement that we have experienced a systemwide event, we have spent very little time discussing the concept of systemic risk, determining how best to regulate it, or even establish whether it can be regulated at all.

Third, I believe that regulators should have clear and manageable responsibilities and be subject to oversight and proper accountability. I am concerned that we already have a number of regulators that do not currently meet these criteria, and the administration is contemplating giving them additional responsibilities. For example, the Federal Reserve already handled monetary policy, bank regulation, holding company regulation, payment systems oversight, international banking regulation, consumer protection, and the lender-of-last-resort function. These responsibilities conflict at times, and some receive more attention than others. I do not believe that we can reasonably expect the Fed or any other agency effectively play so many roles.

In addition, the Federal Reserve was provided a unique independent status to assure world markets that monetary policy would be insulated from political influence. The structure of the Federal Reserve involves quasi-public reserve banks that are under the control of boards with members selected by banks regulated by the Fed. By design, the board and the reserve banks are not directly accountable to Congress and are not easily subject to congressional oversight. Recent events have clearly demonstrated that the structure is not appropriate for a Federal banking regulator let alone a systemic regulator.

Finally, while we have a responsibility to identify and repair the weaknesses of our current regulatory structure, we also have a duty to position our regulatory system for the future. Since World War I, we have been the world's financial market of choice. That is rapidly changing. We must do everything we can to not only ensure the safety and soundness of our financial system, but also its competitive standing in the world.

The President has now added his voice to the debate, and it is now up to us to add ours. As we do, I hope that we will not allow the administration's recommendations to limit the debate that we are about to undertake. While we have a very difficult task before us, I also believe we have a unique opportunity to do something significant.

I urge my colleagues to focus on creating a regulatory system for the next century, not one that merely seeks to remedy the mistakes of the last few years.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Mr. Secretary, we welcome you once again before the Committee and look forward to your testimony. And, by the way, any supporting documents and other materials—Senator Shelby recommended that it might be helpful for the Committee to see and discuss with you and your staff and others the background material that you used in formulation of this could be helpful as well as we move forward. So I welcome that suggestion by my friend from Alabama.

I would say, by the way, all statements of my colleagues as well and any data and supporting material they would like to be included in the record of this hearing will be—we will just consider that done as well as we move forward.

Mr. Secretary, welcome.

STATEMENT OF TIMOTHY GEITHNER, SECRETARY, DEPARTMENT OF THE TREASURY

Secretary GEITHNER. Mr. Chairman, Ranking Member Shelby, and Members of the Committee, it is a pleasure to be here. I welcome this debate. This is a critically important debate for our country, and I think it is time we get to it.

Over the past 2 years, our Nation has faced the most severe financial crisis since the Great Depression. Our financial system failed to perform its critical functions. The system magnified risks. Some of the largest institutions in the world failed. The resulting damage affected the country as a whole, affecting virtually every American. Millions have lost their jobs and their homes. Hundreds and thousands of small businesses have shut down. Students have deferred college and education, and workers have had to shelve their retirement plans.

American families are making essential changes in response to this crisis. It is our responsibility to do the same, to make our Government work better. And that is why yesterday President Obama unveiled a sweeping set of regulatory reforms to lay the foundation for a safer, more stable financial system, one that can deliver the benefits of market-driven financial innovation even as it guards against the dangers of market-driven excesses.

Every financial crisis of the last generation has sparked some effort at reform, but past efforts have been begun too late, often after the will to act has subsided. We cannot let this happen this time. We may disagree about the details, and we will have to work through these issues. But ordinary Americans have suffered too much. Trust in our financial system has been too shaken, and our economy was brought too close to the brink for us to let this moment pass.

In crafting our plan, the administration has sought input from all sources. We consulted extensively with Members of Congress, regulators, consumer advocates, business leaders, academics, and the broader public. And we looked at a range of proposals made by a number of bodies here in the United States over the last several

months. We considered a full range of options, and we made the judgment that now was the time to pursue the essential reforms, those that address the core causes of the crisis and those that will help prevent or contain future crises.

I want to be clear. Our plan does not address and does not seek to address every problem in our financial system. That is not our intent, and we do not propose reforms that, while desirable, would not move us toward achieving those core objectives of creating a more stable system and addressing those vulnerabilities that are critical to our capacity to prevent future crises.

We have laid out the details of our proposals in public, so I just want to spend a few minutes explaining some of the broad principles that guided our proposals.

First, if this crisis has taught us anything, it is that risks to our system can come from almost any quarter. We must be able to look in every corner and across the horizon for dangers, and our system was not able to do that.

While many of the firms and markets at the center of the crisis were under some form of Federal regulation, that supervision did not prevent the emergence of large concentrations of risk. A patchwork of supervisory responsibility, loopholes that allowed some institutions to shop for the weakest regulator, and the rise of new institutions and instruments that were almost entirely outside the Government's supervisory framework left regulators largely blind to emerging dangers. And regulators were ill equipped to spot systemwide threats because each was assigned to protect the safety and soundness of individual institutions under their watch. None was assigned to look out for the broader system as a whole.

That is why we propose establishing a Financial Services Oversight Council to bring together the heads of all the major Federal financial regulatory agencies, and this council will help ensure that we fill gaps in the regulatory structure where they exist and where they emerge. It will improve coordination of policy and help us resolve disputes across agencies. And, most importantly, it will have the power to gather information from any firm or market to help identify and help the underlying regulators respond to emerging risks.

The council will not have the responsibility for supervising the largest, most complex, interconnected institutions, and the reason for that is simple. That is a highly specialized, complicated task, and it requires tremendous institutional capacity and organizational accountability.

Nor would the council be an appropriate first responder in a financial emergency. You cannot convene a committee to put out a fire. The Federal Reserve is the best positioned to play that role. It already supervises and regulates bank holding companies, including all major U.S. commercial and investment banks. Our plan is to give it a carefully designed, modest amount of additional authority, and clearer accountability for the Fed to carry out that mission, but we also take some important authority and responsibilities away from the Federal Reserve.

Specifically, we propose removing from the Federal Reserve and other bank regulators oversight responsibility for consumers. Historically in those agencies, consumer interests were often perceived

to be in conflict with the broader mandate of the institutions to protect safety and soundness.

That brings me to our second key priority: consolidating protection for consumers and ensuring they understand the risks and rewards associated with financial products sold directly to them. Before this crisis, many Federal and State regulators had authority to protect consumers, but few viewed it as their primary mission. As abusive practices spread, particularly in the market for subprime and nontraditional mortgages, our regulatory framework proved inadequate. And this lack of oversight, as the Chairman said, led millions of Americans to make bad financial decisions that emerged as a core part, a core cause of this crisis. Consumer protection is not just about individuals, but it is also about safeguarding the system as a whole.

Now, this Committee, the Congress, and the administration have already taken important steps to address consumer problems in two key markets—those for credit cards and the beginning mortgages—and our view is that those are a sound foundation on which to build more comprehensive reform.

We propose the establishment of a Consumer Financial Protection Agency to serve as the primary Federal agency looking out for the interests of consumers of credit, savings, payments, and other financial products. This agency will be able to write rules that promote transparency, simplicity, and fairness, including standards for standardized, simple, plain vanilla products that have straightforward pricing.

Our third priority is to make sure that reform, while discouraging abuse, encourages financial innovation. The United States remains the world's most vibrant and most flexible economy in large measure because our financial markets create a continuous flow of new products, services, and capital. That makes it easier for the innovator to turn a new idea into a growing company.

Our core challenge, though, is to design a system which has a proper balance between innovation and efficiency on the one hand and stability and protection on the other. We did not get that balance right, and that requires substantial reform. We think the best way to keep the system safe for innovation is to have stronger protections against risk with stronger capital buffers, to have greater disclosure so that investors and consumers can make more informed financial decisions, and a system that is better able to evolve as innovation advances and the structure of our financial system changes in the future.

Now, I know that some suggest we need to ban or prohibit specific types of financial instruments as too dangerous, and we are proposing to strengthen consumer protections and investor protections and enforcement by, among other things, prohibiting a range of abusive practices, such as paying brokers for pushing consumers into higher-priced loans or penalties for earlier repayment of mortgages.

In general, however, we do not believe you can build a system based on—a more stable system based on an approach of banning on a periodic basis individual products because those risks will simply emerge quickly in new forms. Our approach is to let new prod-

ucts develop, but to bring them into a regulatory framework with the necessary safeguards in place.

Our tradition of innovation in the financial sector has been central to our prosperity as a country, so our reforms are designed to strengthen our markets by restoring confidence and accountability.

Finally, Mr. Chairman, a fourth priority is to address the basic vulnerabilities and our capacity to manage future crises. We came into this crisis without an adequate set of tools to confront and deal with the potential failures of large, complex financial institutions. That left the Government with extremely limited choices when faced with the failure of the largest insurance company in the world and some of the world's largest investment banks. And that is why, in addition to addressing the root causes of this crisis, putting in place a better framework for crisis prevention in the future, we have to act to give the Government better tools to manage future crises.

At the center of this, we propose a new resolution authority modeled on the existing authority of the FDIC to manage the failure of weak thrifts and banks, and that will give us more options in the future that we should have had going into this crisis. This will help reduce moral hazard by allowing the Government to resolve failing institutions in ways that impose costs on owners, creditors, and counterparties, making them more vigilant and prudent.

Now, we have to also minimize moral hazard created by institutions that emerge with a scale and size that could threaten stability. No one should assume that the Government in the future will step in to bail these institutions out if they fail. We will do this by making sure financial firms follow the example of families across the country and build bigger protections, bigger cushions, bigger safeguards as a precaution against bad times. We will require all firms to keep more capital and more liquidity on hand as a greater cushion against future losses and risks, and the biggest, most interconnected firms will be required to keep larger cushions, larger shock absorbers against future shocks.

Now, the critical test of our reforms will be whether we make the system strong enough to withstand the stress of future recessions and strong enough to withstand the failure of large institutions in the future. These are our basic objectives. We want to make the system safer for failure and safer for innovation. We cannot afford inaction. As both the Chairman and Ranking Member said, I do not think we can afford a situation where we leave in place vulnerabilities that will sow the seeds for future crises, so we look forward to working with this Committee in the weeks and months ahead to put in place a stronger foundation for a more stable financial system in the future.

Thank you very much, Mr. Chairman.

Chairman DODD. Thank you very much, Mr. Secretary.

We have a full complement of Members here this morning, and so I am going to be a bit more disciplined about the 5 minutes. That way we can get through the Members who are here; otherwise, if it goes on too long, we do not get a chance to do that. So I will instruct the clerk to put that clock on, and if Members would be careful to watch it themselves so we get to include everyone in the questioning this morning.

Let me begin, Mr. Secretary, with a question regarding mortgage protections. I strongly support your notion of a Consumer Financial Protection Agency. I would point out to you, as I know you are aware as well, we gave the authority back in, I think, 1994 with the HOEPA legislation. It was not a request but it was a mandate that they formulate regulations to protect against some of the very abuses that led to the mortgage crisis in the country. And so merely designating someone to do a job does not always get the job done, obviously, as we have learned painfully in all of that.

What I would like to know is, while it is not included specifically—and the other body, the House, has dealt with this differently—there is a strong interest on this Committee to deal with the mortgage reform provisions in the bill. And what I want to get from you, if I can, at the outset, would you be willing to work with us on including language as part of this overall reform effort that would do that as well?

Secretary GEITHNER. Yes. We think that is very important.

Chairman DODD. Well, I appreciate the answer to that.

Let me go to the issue—and, again, I want to state—I think all of us have had a chance to talk about this, and obviously the debate about, one, whether or not you want a systemic risk regulator, which I certainly do, and then the question who does it and what authorities do you give them.

From my standpoint, I am open on the issue. I have not made up my own mind what is the best alternative. Obviously, you have submitted a plan that gives that authority to the Fed. But let me raise some questions that have been raised by others about the wisdom of that move to the Fed and not looking at the more collegial approach or some other alternative.

A fellow by the name of Mark Williams, a professor of finance and economics at Boston University and a former Fed examiner, said the following: "Giving the Fed more responsibility at this point"—and he had a rather amusing analogy—"is like a parent giving his son a bigger, faster car right after he crashed the family station wagon."

SEC former Chairman Richard Breeden testified before this Committee, and he said the following: "The Fed has always worried about systemic risk. I remember in 1982 and 1985 the Fed talking about that it worried about systemic risk. They have been doing that, and still we had a global banking crisis. The problems like the housing bubble, the massive leverage in the banks, the shaky lending practices, and subprime mortgages, those things were not hidden. They were in plain sight."

And perhaps most significantly, Chairman Volcker in response to a question by Richard Shelby back in February in a hearing we had in this Committee testified that he had concerns about giving the Fed too many responsibilities that would undermine their ability to conduct monetary policy.

So the question that many are asking, not just myself but others on this Committee and elsewhere, is: Given the concerns that have been expressed by the former Chairman of the Federal Reserve, the former Chairman of the SEC, and others about the Fed's track record as well as the multiple responsibilities that the Fed already has, why is it your judgment that the Fed should be given this ad-

ditional extraordinary authority and power? And does it not conflict in many ways or could it not conflict with their fundamental responsibility of conducting monetary policy?

Secretary GEITHNER. Mr. Chairman, I agree with you. These are some of the most important issues we are going to have to confront together, and I think that you and many others have expressed a number of thoughtful concerns about not just the role of the Fed going forward, but how to think about the right mix of accountability and authority in these areas. So let me just say a few things in response.

I think you need to start—we need to start with the recognition that central banks everywhere around the world, in this country and everywhere else, were vested with the dual responsibility at the beginning for both monetary policy and some role in systemic financial stability. That is true here. It is true everywhere. And there is no, I believe, no necessary conflict between those two roles.

For example, the Fed has got an exemplary record of keeping inflation low and stable over the last 30 years, even though it had the set of responsibilities you outlined that take it into the areas of financial stability. So I see no conflict.

The second point I would make is the following. If you look at the experience of countries in this financial crisis who have taken away from their central bank, from their equivalent of our Federal Reserve, and given those responsibilities for financial stability, for supervision, for looking across the system to other agencies, I think they found themselves in a substantially worse position than we did as a country, with in many ways a worse crisis, with more leverage in their banking systems, with less capacity to act when the crisis unfolded, for a simple basic reason, I think.

If you require a committee to act, if the people that have to act in the crisis, if the fire department has no knowledge of the underlying institutions it may have to lend to in crisis, it is likely to make less good judgments in that context. It may be too tentative to act or it may act less with—too indiscriminately in a crisis in that context.

So if we look at the experience of many countries in the docudiffer model, it is not encouraging. The model where you take those responsibilities away from the central bank and vest them somewhere is not an encouraging model, in our judgment. I think you see those countries, if you listen carefully, moving in the other direction.

Just a few other quick things in response. Our proposals for the additional authority we are giving the Fed are actually quite modest and build on their existing authorities. So, for example, the Fed already is the holding company supervisor of the major firms in the United States that are banks, or built around banks, but it was not given in Gramm-Leach-Bliley clear accountability and authority. It was required to defer to the functional supervisors responsible for overseeing the banks and the broker dealers. That is a bad mix of responsibility without authority, but we are proposing just to tighten that up and clarify it so they feel perfectly accountable for exercising that authority.

In the payments area, the Fed has a general responsibility for looking at payment systems, but very limited, weak authority in

terms of capital, which is essential to our reform proposals and central to any effort to create a more stable system. The Fed has some role today in helping set capital requirements, but that role is very constrained by the requirements of consensus across a very complicated mix of other regulatory authorities.

Those are the key areas where we propose giving the Fed modest additional authority and clarify accountability for responsibility. They are not a dramatic increase in powers. We are proposing to take away from the Fed responsibility for writing rules for consumer protection and enforcing those rules. That is a substantial diminishment of authority and preoccupation and distraction. We are also proposing to qualify their capacity to use their emergency powers to lend to an institution they do not supervise in the future and to require that to exercise that authority, they require the concurrence of the executive branch.

So we proposed what we believe is a balanced package over this set of independent regulatory authorities for consumer protection, for market integrity, for resolution authority. We propose establishing a council that will play the necessary coordinating role. That will provide some checks and balances against the risk that those underlying agencies get things wrong. It provides the capacity to deal with gaps, adapt in the future. So those are some of the reasons.

I want to just say one more thing to end. I don't think there is any regulator or any supervisor in our country, and I think this is true for all the other major economies, that can look at their record and not find things that they did not do well enough. That is certainly true of the Fed. On the other hand, if you look at where risks were most acute in our country, where underwriting standards were weakest, where consumer protections were least adequate, again, where systemic risk that threatened the system was most acute, those developed largely outside the direct and indirect purview of the Fed and the Fed was left with no responsibility and no ability to contain those basic risks, and that is an important thing for us to change if we are going to build a stronger system.

Chairman DODD. Well, thank you for that. I only wish that the consumer protection had been more of a distraction at the Fed. In the HOEPA legislation in 1994, it was certainly an example where they dropped the ball entirely and had that authority. My time is up, but that is an underlying concern.

Anyway, let me turn to Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Accountability at the Fed—Mr. Secretary, the Federal Reserve System was not designed to carry out the systemic risk oversight mission the administration proposes to give it. It is not a sole institution run under the direction of a single, ultimately responsible leader. Rather, it is a Federal system composed of a central governmental agency, the Board of Governors, and 12 regional quasi-public Federal Reserve Banks. The Board, as you well know, contains seven members. The Reserve Banks are run by presidents—you were one—who are selected by and subject to the oversight of each individual bank's board. Within the system, the Board and the Reserve Banks share responsibility for supervising and regulating certain banks and financial institutions.

With decision-making authority dispersed to the Board and Reserve Banks, who will be accountable to Congress for the systemic risk regulation function as the "system" cannot appear to testify right here before Congress?

Secretary GEITHNER. Senator Shelby, you are right that the Federal Reserve structure, the system established by the Congress almost 90 years ago for the Federal Reserve, is a complicated mix of different things. You are absolutely right. And we are suggesting—we do propose in our recommendations that the Fed take a close look, in consultation with outside experts and the Treasury, and come forward with proposals by, I believe we say the end of October, for how to adapt that basic governance structure to respond to some of the concerns you have raised and we have talked about before. And I think there are things that the Fed should reflect on there that would provide a better balance, reduce the risk of perceived conflict in these areas.

But I think the short answer to your question is to say the Chairman of the Board of the Federal Reserve would be accountable, as he is now. And I think in the current framework of the Fed as designed by the Congress, the responsibilities for supervision, to the extent the Fed has them now, are concentrated at the Board of Governors, overseen by a board of people appointed by the President, confirmed by the Senate, and that Board and that Chairman would be the one accountable to you.

Senator SHELBY. Mr. Secretary, the administration's proposal chooses to grant the Fed authority to regulate systemic risk because, "it has the most experience to regulate systemically significant institutions." I personally believe this represents a grossly inflated view of the Fed's expertise. Presently, the Fed regulates primarily bank holding companies and State banks. As a systemic risk regulator, the Fed would likely have to regulate insurance companies, hedge funds, asset managers, mutual funds, and a variety of other financial institutions that it has never supervised before.

Since I believe the Fed lacks much of the expertise it needs to have as an effective systemic regulator, why couldn't the responsibility for regulating systemic risk just as easily be given to another or a newly created entity, as some have proposed?

Secretary GEITHNER. Excellent question, and let me say a couple things in response. First is we did not envision quite that sweeping a scope or authority as you implied in your basic question. Our judgment is the core institutions at the center of the system that require a stronger framework of consolidated supervision and higher capital requirements at this stage—we have to go through a careful process to assess this—at this stage would largely entail the major banks and investment banks in the country today. Now, there are some exceptions to that.

But we also believe that we want to have a system that is flexible enough in the future if other institutions emerge that could present the same kind of risks to the system that we saw emerge from AIG or from Bear Stearns and Lehman Brothers, that we want the system to be able to adapt and bring those institutions under the same basic framework of constraints on leverage that we think are appropriate for those banks at the core of the system that could threaten stability. But we do not envision quite as sweeping

and broad a net as you suggested in your initial remarks, and that is one reason why we think the natural place for this is the Fed.

Now, the Fed—again, the Fed has, relative to any other entity in our current system today, much more knowledge about how payment systems work. It is, because it does execute monetary policy on behalf of the Federal Reserve of the FOMC, and because it does fund the government on behalf of the Treasury, it has a greater knowledge and feel for broader market developments than is true for any other entity in that context. These things are all about alternatives and about choices. We don't think it is tenable to give those responsibilities to a committee, for reasons I think you understand. And we do not believe there is another place in the system better able to handle those responsibilities. And we think to create a new institution from scratch would leave us with a risk of losing, or not having in a moment of significant challenge, having the necessary expertise and experience.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman DODD. Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman, and I want to thank you and congratulate you on the blueprint that you put together, Secretary Geithner, because I do believe it will close many of the most important regulatory gaps in our system. There are a few issues where I think the administration should have pushed a bit farther, but this is an excellent framework and charts a clear course to fix the problems that led us to the crisis.

Two places I would like to just give you a pat on the back, I agree with Senator Dodd, a Financial Consumer Product Safety Commission is essential. The Fed failed significantly in this responsibility. So while you have got to be leery of starting over, in this case, you have to start over and a new agency is what is called for.

Second, of less noticed but of great importance is the idea that the mortgage issuer and securitizer must hold a piece of the mortgage. That would have stopped Countrywide and others like it in its tracks. It certainly would have greatly lessened the crisis. It might have even avoided it. So that is a great addition, because now they can't issue these junky mortgages and then just not hold them and sell them.

On the systemic risk regulator, we need one, there is no question, and the old way is certainly bad. We can criticize any proposal, but keeping the present system is worse. Every agency had a piece of the system to oversee and protect, but nobody had responsibility to mind the whole store rather than just looking after individual aisles. I agree with Senator Shelby, it is really hard to do. But, tackle it we must, or we risk having the same kind of widespread financial crisis that we have just been going through. You cannot let the perfect be the enemy of the good here or we end up with less, and believe me, it is hard to do.

Who predicted—you could probably count on your hands and toes the number of people in financial services, the commentators, the press, in government, who predicted 5 years ago that mortgages and this mortgage crisis would bring the whole system down. It is very hard to see around the corner.

And my view, I tend to agree—I am not certain, but I tend to agree that the Fed is the best answer. There are no great ones. A

council? That is a formula for disaster in something like this. A council, everyone will pass the buck and it will stop nowhere. You must have the buck stop somewhere with systemic risk.

So then maybe you should have a new regulator, just someone new. The problem is, you need deep, deep knowledge of how the financial system works and a new council is going to be much slower to start. The Fed has that knowledge. You could argue the reason the Fed failed in the past, and it did, was because of the attitude of some of the people at the top who were for abject deregulation rather than the structure, but to me at least, until shown a better example, I think the Fed, at least tentatively, is the best one.

The question I wanted to ask you is about bank responsibility. For years, everybody has said one of the problems of banking regulation is that it is too divided up. The system allowed banks, most recently and notably again Countrywide—that has been a nemesis to me—to game the system for the slightest regulation possible, yet your plan, while consolidating OTS and OCC, leaves significant prudential supervisory authority with the Fed and FDIC. If you count the new consumer watchdog agency, which I am all for, there would be four bodies involved in bank supervision, the same as we started with, no consolidation. A multiplicity of regulators tends to produce less oversight overall. The whole is greater than the sum of its parts when it comes to a symphony orchestra or the New York Giants, but with our patchwork system of banking regulators, the whole is less.

So please tell us why you didn't do more consolidation, and particularly with the Fed gaining these powers, why do they have to be the supervisor of State banks, setting up this duplication of systems where you have a Fed regulator, the OCC, for the same exact bank who then shops around to be State chartered? If you want to remove another power from the Fed, which is getting a lot, take it away. Don't have them regulate State banks. Why didn't you consolidate the banking regulators more?

Secretary GEITHNER. Senator, we thought a lot about that, and I think nobody would argue if we were starting from scratch today that we would replicate the current structure that we have of 50 State-level supervisors of banks, one at the Federal level—we are proposing one at the Federal level—and it is a complicated structure and I don't think anybody would advocate starting from that if we were starting from scratch.

But I think it is fair to say, and the basic principle that guided our proposals was we wanted to make sure we are focusing on those problems that were central causes of this crisis, and we do not want to put you in the position of having to spend a lot of time on changes that may be desirable, may leave us with a neater system, maybe a more efficient system, but were not central to the cause of the problem.

And in our judgment, the central source of arbitrage opportunity, the central problems we had were banks were able to evade stronger standards applied by one supervisor—in this case, it was the Fed's stronger standards that left Countrywide and others to flip their charter to a thrift. The basic problem we faced was in the thrift charter.

Now, there are thousands of thrifts across the country that are well managed, were very conservative, demonstrated admirable capacity to meet the needs of their community, but in the case of too many of the celebrated failures that helped magnify this crisis, that arbitrage opportunity was central to the problem. So if you just look at AIG, Countrywide, you have described many of them, you can see examples of that basic problem.

So we thought it was necessary to fix that problem, but while it was not essential to take on that more complicated challenge of fundamentally transforming the rest of the system where there is a balance now between State and Federal supervision of State-chartered banks.

Now—and again, if you look at the opportunities that exist now, problems created by the potential to shift from a State charter to a national charter, I think because there are stronger, more uniform standards in place now across those banks, those problems—they are material in some cases, but they are much, much less significant. So we are making a pragmatic choice to focus on things that were a central cause of the crisis, leaving aside for the moment changes that many would support but we don't think are necessary to do just now.

Senator SCHUMER. Thank you.

Chairman DODD. Senator Bennett.

Senator BENNETT. Thank you very much, Mr. Chairman.

Mr. Secretary, good to see you and you continue to have interesting days in the Chinese sense of that term.

I don't want to be overly parochial about this, but there is one section of this thing that does affect my State pretty directly, and since I only have 5 minutes, that is what I will focus on.

Right now, one of the problems we have in the economy is that there is not enough credit. We keep hearing, well, I can't get a loan. I have got a good deal, but I can't get a loan. I can't get any help. And in this proposal, you are killing one very major source of credit where there has been no difficulty with respect to the crisis. You said, we are trying to deal with those that were essential to the crisis. I am talking about ILCs. There is not a single ILC that contributed to the crisis. There is not a single ILC that went down. And interestingly, when Lehman Brothers went down, one of the crown jewels of the bankruptcy was, well, at least they have got an ILC that is functioning and that is financially sound.

And you talk about adding a modest amount of increased power to the Fed. In this case, it is not a modest amount of increased power, it is actually a destruction of the industry. We are going to cancel the ILC charter. We are going to cancel the industry as a whole.

So my basic question to you is, why does the elimination of ILC, thrifts, and commercial ownership of banks make the system stronger and safer when you have a track record, at least with the ILCs, that says that they, in fact, by virtue of their ownership have been stronger than the banks? So you are going to wipe them out as a source of credit, take them out of the marketplace where they are providing niche credit for people that don't otherwise get it, and I would like to compare that track record with the track record of

bank holding companies if you are going to say, where do you have a source of strength.

Secretary GEITHNER. Senator, I agree, this is a very complicated issue and it is hard to be sure what the right path is here. But let me just try to explain the basic principles that underpin this basic reform.

Institutions that do things like take deposits and make loans, institutions that do things that are basic banking activities, they transform short-term liabilities into long-term assets, need to come within a common framework of standards and constraints and oversight. That is the basic principle we establish. If we do not do that, then people—all the risk in the system will migrate to those parts of the system where you can do similar activities but not be subject to the same basic standards. So our basic principle is a simple one, is that we want to eliminate those gaps and loopholes that allow institutions to evade those basic standards.

Now, again, we are trying to be careful to take on things that are essential, but that principle, I think, is an essential principle. Now, we may disagree on how best to do that, and we would be happy to work carefully with you. We want to be careful not to do what you suggest that we are doing, which is to, in either the near-term or the long-term, diminish the credit-creating capacity of this financial system, and I don't think our proposal carries that risk. But I understand your concern and we will be happy to work with you to make sure that we do this carefully.

Senator BENNETT. I just want to make the point that the theory is fine. The practice says that this is an area that worked. So one of the first things I notice in the President's proposal is we are going to take an area that worked and we are going to abolish it in the name of trying to make the system that hasn't worked a little bit stronger. I just have a very serious problem with that.

Secretary GEITHNER. Well, as I said, I understand your concern and we are happy to work with you and we will work with you closely and try to address that concern. But again, it is true that the basic opportunity created by our structure, particularly in the area of some thrifts, to evade the stronger protections that exist for other institutions, did create and did add to the substantial degree of vulnerability we saw in our system. So we don't want to leave in place the same type of vulnerability, allow people to shop for a weaker regime with less rigorous standards.

Senator BENNETT. You are engaged in overkill, in my view, here. I know that the Fed has been after regulation of the ILCs for as long as they have been around. The Fed seems offended somehow that the regulation of ILCs is left to people like Utah and the FDIC. And so as a matter of principle, the Fed wants to control these. We have always prevented the Fed bureaucracy from getting their hands on these. So now, well, if we can't get our hands on them in the normal fashion, we will just kill them. So I think the message I want to give and I hope I have given is that we are going to look at this one very, very closely.

Secretary GEITHNER. One of the great virtues of our system is we can't do this without your support and encouragement of this body here, and so we recognize in all these areas where legislation is required we are going to have to work to try to persuade you of the

merits of these proposals and take your concerns into consideration.

Senator BENNETT. Thank you very much.

Chairman DODD. Thank you, Senator, very much.

Senator Akaka.

Senator AKAKA. Thank you very much, Mr. Chairman.

Mr. Secretary, our current regulatory structure, I feel has failed to adequately protect working families from predatory practices. Working families are exploited by high-cost fringe financial service providers, such as payday lenders and check cashers. Individuals trying to cope with their debt burdens are pushed into inappropriate debt management plans by disreputable credit counselors or harmed by even debt settlement agencies.

Mr. Secretary, agencies already have had the responsibilities in these areas, but what will be done to ensure that the Consumer Financial Protection Agency will be able to effectively protect working families?

Secretary GEITHNER. Senator, that is an excellent question. As you know, we are proposing the following things to try to be responsive to those basic failures in consumer protection. The first is to create a new agency that would take the existing authority, responsibility, and the expertise, put it into one place with a single core mission of better protecting consumers from the risks they have been exposed to in the marketing of products, particularly credit products to consumers. We are going to give that agency new—we are going to give it exclusive rule-writing authority and primary enforcement authority in one single place of accountability.

We have laid out a set of broad standards and principles built in many ways on the credit card legislation that moved through this Committee and a range of other proposals from the consumer advocates and others that would guide the writing of rules and regulations in these areas.

The basic principles are: Much stronger disclosure, more simple disclosure so that consumers understand the risks in the products they are being sold; the creation of an option to elect for a more simple standardized instrument, standardized mortgage product, for example, so that, again, you are less vulnerable to the risks of predation in these areas; and, of course, there are some practices that we think fundamentally are untenable and should not be permitted which we would propose to ban. We have laid out some of those broad principles in our paper, but that is the approach we recommend.

Senator AKAKA. Mr. Secretary, I have concerns about mandatory arbitration clause limitations. I believe we share a concern on that and that it has been harmful to consumers. I have reintroduced my Taxpayer Abuse Prevention Act. The Act is intended to protect Earned Income Tax Credit recipients from predatory refund anticipation loans and expand access to alternative forms of receiving refunds. The legislation also includes a provision that would prohibit mandatory arbitration clauses for refund anticipation loans to ensure that consumers have the ability to take future legal action if necessary.

Please share with the Committee why the Consumer Financial Protection Agency should have the authority to restrict or ban mandatory arbitration clauses.

Secretary GEITHNER. Senator, I would ask you to give me a chance to reflect on that more carefully and get back to you in writing with a more thoughtful response. But I will work with your staff, you and your staff and try to make sure we understand that risk and see if we can be responsive to that concern.

Senator AKAKA. Thank you. Too many Americans, Mr. Secretary, lack basic financial literacy. Without a sufficient understanding of economics and personal finance, individuals cannot appropriately manage their finances, evaluate credit opportunities, successfully invest for long-term financial goals, or even cope with difficult financial situations. One of the root causes of the current economic crisis was that people were steered into mortgage products with costs or risks that they could not afford.

Mr. Secretary, the proposal indicates that the Consumer Financial Protection Agency will have important financial education responsibilities. How will the CFPA interact with the Financial Literacy and Education Commission and the President's Advisory Council on Financial Literacy?

Secretary GEITHNER. Senator, I just want to agree with you that I think a better basic education about economics and finance is a very important thing for us to work to promote. I think it has to happen early in life. It has to happen in what we teach people in schools. Experience is the best teacher, and this experience will be a searing—this crisis provides a searing set of lessons that will, I think, change behavior fundamentally.

But I think we can do a better job as a government in trying to support programs that do a better job of promoting financial literacy and I think the best thing I can say is they are going to work closely together to try to make sure that we are using the taxpayers' money as effectively as possible in support of those programs.

Senator AKAKA. Mr. Secretary, I appreciate all of your efforts to better protect, educate, and empower consumers. I look forward to continuing to work with you, the rest of the administration, and the Members of the Committee to better educate, protect, and empower consumers. This issue is so important because it has tremendous potential to improve the quality of life for our working families.

Mr. Chairman, I also appreciate all of your efforts to protect consumers. Thank you very much, Mr. Chairman.

Senator JOHNSON [presiding]. Senator Vitter.

Senator VITTER. Thank you. Thank you, Mr. Secretary, for being here.

Mr. Secretary, did Fannie Mae and Freddie Mac, problems there, play a role in the recent financial crisis?

Secretary GEITHNER. Absolutely.

Senator VITTER. So going back to the fundamental focus you said you all have for this plan to take care of the core problems that we saw over the last year, why are we punting to the future Fannie Mae and Freddie Mac, maybe we will get around to it next year——

Secretary GEITHNER. Good point.

Senator VITTER. ——at the same time regulating areas that were not part of the problem in the last year, as Senator Bennett mentioned? I mean, to me, at least, it seems like we are ignoring a core problem in the governmental sector and we are regulating areas in the private sector that were not part of the problem in terms of the last year, and that seems very much at odds with what you said was your rationale in focusing on these items and not others.

Secretary GEITHNER. Accepting Senator Bennett's point as I did, which we will have to talk—we will have to spend some time talking through—I did not believe we are proposing here to try to solve problems that were not problems.

Fannie and Freddie were a core part of what went wrong in our system, but Congress did legislate last year a comprehensive change in their oversight regime, and just to be fair and frank, we did not believe that we could at this time, in this timeframe, lay out a sensible set of reforms to determine what their future role should be as we get through this crisis. We want to do that carefully and well and we did not think that was necessary to do at this stage. But as we said in the report, we are going to begin a process of looking at broader options for what their future should be and what should be the future role of those agencies in the housing market in the future. We just didn't think it was essential to do just now, but it is an essential thing to do. We couldn't do it carefully enough, thoughtfully, in this timeframe.

But as you know, Congress did legislate last year a comprehensive new oversight regime in place over those institutions. If that had been in place before, that might have helped mitigate this crisis.

Senator VITTER. Well, I just underscore the point that if we can consider all of these changes on the private sector carefully and thoughtfully in this timeframe, and I have my doubts about that, but if we can do that in this timeframe, I think we can attack the Fannie–Freddie issue in this timeframe, as well.

Secretary GEITHNER. Can I just—I think this is a very important issue and you are asking a very good question. It is a very different challenge. Our challenge with Fannie and Freddie now, and this is true about the government's role in the housing market more generally, is more a challenge for exit, what the future should be. We have to fundamentally rethink what the appropriate role of the government is in the future. We did not get that right. It was not a tenable balance we struck in that situation.

But it is a different challenge now that we face in putting in place the foundations of a more stable system, a clearer set of rules of the game, stronger consumer protections. It is more about a range of questions we face about how the government gets out of and dials back and reverses these extraordinary interventions we have been forced to undertake to help protect the system from this crisis.

Senator VITTER. Mr. Secretary, the creation of this Tier 1 of institutions, tell me why that isn't a big flashing neon sign, "too-big-to-fail"?

Secretary GEITHNER. We are very worried about the same basic problem, designed as carefully as we could to mitigate that risk,

but we haven't eliminated it completely. So let me just say a few things in response to that concern.

Right now in the United States of America, we have a set of institutions that are of a—play a role in markets, it is probably because of size, but it is not principally because of size—you know, Bear Stearns and Lehmans were not that large—but play a role where their health and safety is critical to the stability of financial markets. Those institutions need to be subjected to stronger, more conservative constraints and leverage and we need to have the capacity through resolution authority, like we have for banks and thrifts now, to deal with their prospective failure in the future.

Our judgment is the combination of those two things, the explicit change in policy now to recognize that those institutions need to be subjected to more conservative constraints on risk taking, combined with resolution authority to give the government better tools to manage their failure when that happens, will help mitigate the inherent moral hazard risk in any system that comes from the emergence of large institutions.

Now, just one final thing, because this is an important kind of thing—an important issue. If you look at our system today, we are substantially less concentrated than the banking system of almost—I think of any major economy in the world. Less so than Canada. Less so than most of the countries in Western Europe. We have thousands of small institutions that play a critical role in creating a more resilient, more stable system. We want to preserve that balance. And by establishing this important change in principle of higher standards, higher capital requirements on the largest, we will help mitigate the risk in the future that we see future consolidation to a point that would leave us with a more vulnerable system.

Senator VITTER. Mr. Chairman, if I could just ask one more question quickly, a lot of my concerns also go to the role of the Fed and the independence of the Fed and I would note two huge concerns. One is that under this plan, to use certain expanded powers and emergency steps, the Fed needs approval from Treasury. I think that is a big change in terms of the independence of the Fed. I think that is really crossing a line and a sort of fundamental change in terms of the nature of the Fed and I just point that out as a big concern, because all of a sudden, the Fed is acting more like a department of the government than an independent bank. It is asking Treasury for permission in that circumstance.

Second, my other big concern is that we would be very much diluting the focus of the Fed from stable monetary policy. To me, getting monetary policy right is a big job, and to me it is a crucial job. And I don't think it is any coincidence that when we look at the periods of sustained, robust growth, at least in my lifetime, they coincided with sustained, predictable monetary policy and management. So I also have a fundamental fear of diverting the attention of the Fed on what is already a really big job and a really important job.

I know my time has expired. Thank you, Mr. Chairman.

Senator JOHNSON. Senator Warner.

Secretary GEITHNER. Mr. Chairman? Mr. Chairman, would it be possible for me to respond briefly to his two questions at the end? I think these are——

Senator JOHNSON. Yes. Go ahead.

Secretary GEITHNER. I know that we are going to spend a lot more time on these issues, but I would like to respond quickly on these two points.

It is very important to our country and exceptionally important to the executive branch of the United States and I think to the Congress, that the Fed preserve its independence and its accountability for achieving sustainable growth and price stability over time. At its inception, the Fed was given this mix of responsibilities, both for price stability and for a range of other responsibilities that stray into the areas of financial stability. It is the lender of last resort to the country.

I don't believe there is any conflict between those two responsibilities, and I think the record of the Fed justifies that judgment. But we want to preserve that. In part because of that, we are being careful to make sure the Fed isn't overextended. We are scaling back some of their existing responsibilities even as we tighten the accountability and authority in those core areas.

You were right that to change the way 13(3) now acts—13(3) is the provision of the Federal Reserve Act that gives the ability of the Fed in unique and exigent circumstances to lend to an institution it does not supervise—to require that action require the approval of the Secretary of the Treasury is an important change. But we believe, and I believe the Chairman of the Federal Reserve believes that is an appropriate, justifiable change, in part because of the concerns expressed by many of your colleagues, understandably, about the Fed being pulled into doing things that go well beyond the classic responsibilities of the lender of last resort.

And I think it is a very consequential act for the Fed to lend to an institution it has no supervisory relationship over. It creates an enormous risk of moral hazard. And to limit that authority in the future, I think is a way to help reduce the risk of moral hazard created by the exceptional response that the government has made in this case, and if the Congress provides resolution authority, it gives us a better ability to deal with the potential failure of large systemic institutions in the future and there will be less need for the Fed in the future to use that 13(3) authority to lend to institutions that were not under its supervisory mandate.

One final point. The Fed was very careful, and I think appropriately so, when it acted in this crisis to lend to individual institutions. I will just speak directly about Bear Stearns, in the JPMorgan and Bear Stearns context and about AIG. In that context, because the taxpayer would ultimately bear the losses that might come with any of those basic judgments, the Fed required the concurrence in writing of the Secretary of the Treasury before it took those actions. I think that was an appropriate step then, because ultimately this was the taxpayers' money at risk, and ultimately it is the taxpayers' burden if the government fails to get this balance of moral hazard and safeguards right.

So I think those are some of the reasons why I think this is an important step, but I agree with you that it is a consequential step.

Senator JOHNSON. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman, and thank you, Mr. Secretary. I too have some concerns about the administration's proposals, but let me perhaps acknowledge as at least a marker here, I think there was a piece that Steve Pearlstein wrote in *The Washington Post* recently that if somebody would have said 9 months ago, 6 months ago, or even 3 months ago that we would be sitting near the end of June with the stock market up almost 30 percent, with banks trying to repay some of their TARP funds, and some stabilization in the housing market, I think almost any economist or any market maker would have said that was perhaps a too optimistic a prediction. So while we have concerns, overall directionally I think we are headed in the right direction, and I commend your leadership—although I would ask—and I know under Senator Reed's leadership, he has raised this issue as well. We still have great concerns about what we are going to do with the warrants as these banks go through a repayment process and that we need an overall policy there.

I also want to echo what Chairman Dodd and Senator Shelby have said. I think we realize the responsibility that we have got to get it right; that if we mess this up, the unintended consequences to not only our economic recovery but the overall long-term financial stability for the world is really at stake. So I hope with that caveat I can then issue some of my concerns.

I share a lot of my colleagues' concerns about this expansion of authority within the Fed. I also share some concerns that putting restrictions on the 13(3) powers of the Fed could potentially further politicize. I have made statements already that I actually believe systemic risk ought to be put in a council that would include the Fed, that would include the Treasury Secretary, that would include the prudential regulators, including the SEC, with an independent Chair and a staff that would be solely focused on systemic risk evaluation and have the ability and power to act. I do not believe it would have to be a debating society, and I actually believe that the advisory council that you have set up unfortunately, because it has the ability to gather information but does not have the ability to act in any way, that it is really emasculated, and it will not provide the kind of nonsiloed approach that I think we are looking for. I think systemic risk by its very nature is not something you can predict ahead of time and that the bias out of the Fed will be too much financial institution as opposed to securities concerns, insurance concerns, or others. So I look forward to that conversation.

But I want to come to—I am happy to address those issues—have you address those issues, but I would also like you to explore a little more on the resolution authority.

I concur with you that an expanded resolution authority for financial institutions inside the FDIC may make some sense. I am concerned about how we fund that. I am concerned about additional fees placed on community or local banks to, in effect, take care of the potential failure of a Citibank.

I am also concerned that if we fully fund that on the front end, though, with these major institutions, that pot of money could be too tempting for diversion for other purposes.

I am also concerned about a resolution authority funding cost for nonfinancial institutions that then might be allocated against the banking industry.

If you could spend a little more time—and I think your paper acknowledged there were still questions to be answered in this area, but you are happy to attack my approach on a systemic risk council, but I would also love to hear some additional thoughts on resolution authority and how we fund it.

Secretary GEITHNER. Excellent questions, and we have not claimed to get the details perfectly right on this, and it is going to require a substantial amount of additional effort and care to get the balance right.

Let me start with resolution authority first. Again, we are proposing a model that takes the structure that works well, we have had lots of experience with, and simply adapt it to the somewhat more complicated challenge of large institutions built around banks but are not only banks in some sense.

As our funding mechanism, we are proposing no *ex ante* fund, no *ex ante* fee to fund a fund. What we are proposing is a mechanism whereby in the event the Government were to act under this authority and were to incur a loss as part of that action, then it would be able to recoup that loss—have the obligation to recoup that loss—by assessing a fee over time in the future applied to bank holding companies.

That will help make sure that the burden for that is borne by bank holding companies, not by the 8,000 other financial institutions in the United States that are not smaller community banks in that case that were not responsible for that error. The scope of this authority would be limited to bank holding companies and institutions we designate at the Tier 1 financial holding companies. We expect those to be principally, at least as we see the system today, built around institutions that have banks as part of their structure. And we think that is a better model than the alternatives. And we have been careful, again, not to create something that would be unfair on the burden proposed and limit the moral hazard created by the existence of authority like that.

Senator WARNER. I know my time has expired, but let me just—much more on this, but that would still require, though, the public to step in with taxpayer funds as an effective short-term bridge until you can assess that. And I would—assess that additional fee. I might simply add amongst those Tier 1 financial institutions—and there are clearly questions about designating those Tier 1 financial institutions, which other colleagues have raised, I wonder if there might not be some, in effect, contingent liability that they could hold on their books rather than the public funding this in the interim and then coming back. And if they had that contingent liability on their books that they could keep as their additional equity, that also might help them self-police better amongst their colleagues.

Secretary GEITHNER. We actually did spend a fair amount of time thinking through an idea like that, and it may be that something like that would be feasible as part of this. But we did not see a way to design that that would provide quite the same practical so-

lution to this problem. But it is an interesting idea, and I would be happy to talk to you about that further.

I want to come back on the council thing, but we will have a chance to come back on it.

Senator JOHNSON. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

I was glad to see last month, Secretary Geithner, in an interview with Charlie Rose that "loose money policy was one of the primary causes of the mess we are in." That is a quote from you. So tell me which part of the plan reins in the Fed's loose money policies.

Secretary GEITHNER. Our plan does not address a range of other causes of this crisis, including policies pursued around the world that helped produce a long period of very low interest rates and a very, very substantial boom in asset prices, housing prices, not just in this country but in countries around the world. And I think you are right to underscore the basic fact that a lot of things contributed to this crisis. It was not just failures in supervision and regulation. And as part of what the world does, major countries around the world, in trying to reduce the risk we have a crisis like this in the future, it will require thinking better through how to avoid the risk that monetary macroeconomic policies contribute to future booms and asset prices and credit bubbles of this magnitude.

Senator BUNNING. Your plan puts a lot of faith in the Federal Reserve's ability to spot risk and exercise its power to prevent the next crisis. However, if the Fed and other regulators have been doing their jobs and paying attention to what the banks and other firms were doing earlier this decade, they almost certainly could have prevented the mess. And the Fed has proven it is unwilling to use its power it has. Let me give you an example.

Just look how slow it addressed the credit card abuses, and it took 14 years for the Fed to write one regulation on mortgages after we gave them the power to do that. So giving them the power and making them act are two different things.

What makes you think that the Fed will do better this time around?

Secretary GEITHNER. Well, Senator, as you know, we are proposing—and partly for the reasons you said—to take both rule writing and enforcement authority for the protection of consumers, particularly in the credit product area, and give it to a new agency with sole accountability and responsibility. Now, that will not ensure that that agency acquits itself perfectly over time, but we think that is a necessary step.

Now, on your first point about the capacity of any institution, much less the Fed, to predict and anticipate and preempt any future financial crisis, let me just say a basic view that I have about this stuff. I think we need to be realistic in recognizing that. It will be very hard, perhaps impossible, for any authority, any individual to anticipate and preempt all potential sources of future risk. And I do not think we can design a system that is premised on the ability of any institution to carry that out effectively.

I think the real important thing to do, though, is to make sure we establish much stronger cushions in the system, shock absorbers in terms of capital and liquidity, better capacity to absorb losses, withstand shocks, so that we are better positioned to deal

with potential sources of risk wherever they emerge—and they will emerge. They will emerge. I think that is the only real effective defense, the necessary defense, and I think the critical failure of policy in this country and many countries around the world in coming into this was not to establish up front more conservative constraints on leverage in good times so the system was better positioned to deal with failure wherever it was going to happen.

Senator BUNNING. Thank you. Do you believe these financial reforms need to be bipartisan?

Secretary GEITHNER. I do.

Senator BUNNING. Then why did the administration provide detailed briefings to the entire Democratic side of this Committee on Tuesday before the plan was released but refused to do the same for all Republicans until after the plan was released?

Secretary GEITHNER. Senator, I will say personally what I did. I did personally host a meeting and invited Members of both sides of the aisle to the Treasury several weeks ago to talk through broad elements of strategy. We have been careful to do that, and we will try to be careful going forward, careful to do it in a balanced way, both sides of the aisle going forward.

Senator BUNNING. I am speaking about this week on Tuesday.

Secretary GEITHNER. Well, as I said, I have been careful to try to make sure we are consulting broadly both sides of the aisle, and I will do so going forward.

Senator BUNNING. My last question has something to do with TARP, because the TARP law allows you as the Secretary of the Treasury to extend from the end of this year until next October. I think that is a terrible mistake we made, but I also thought that the entire TARP program was wrong.

Yes or no, are you going to use the power to extend your TARP authority past December 31st of this year?

Secretary GEITHNER. I have not made that judgment yet, and I do not think we are in a position today to make that judgment. As Senator Warner said, you know, there are some important signs of stability, some important signs of healing in the financial sector. But I think it is still early yet, premature to make that judgment.

Senator BUNNING. Then you think that Treasury should have a slush fund of $700 billion under their control, which is what TARP is, because if you do not go above $700 billion, you can use all the money for other purposes.

Secretary GEITHNER. I think what Congress designed in the fall of 2008 gave the executive branch an important set of authorities for trying to respond to the worst financial crisis in generations. I think they did a good job in designing that authority. We are being very careful to use it well.

I want to point out that $70 billion of capital invested by my predecessor have now come back into the Treasury. An equivalent amount of common equity has now been raised by our major banks. And we have not provided any capital to any large institution, with one exception—in this case, it is the substantial problem we inherited in AIG since the administration came into office. So we have been very careful to use those funds prudently to protect the taxpayer, and we will be going forward. But, on the other hand, we are still in the midst of a very challenging recession on a global

scale, and there are a lot of risks ahead still, and we want to be careful and prudent and not prematurely declaring victory and depriving ourselves of the capacity to respond if this were to intensify again.

Senator BUNNING. Thank you.

Senator JOHNSON. Senator Tester.

Senator TESTER. Thank you, Mr. Chairman, and I want to thank you, Secretary Geithner, for being here today. I also want to thank you very, very much for putting forth an initiative that we can start this debate on a real basis.

That being said, there was a question asked by Senator Schumer about starting over, and you said you did not want to start over from scratch. When we have a crisis like we have had—your own words, "the biggest since the Great Depression"—why not start with a framework that really will be the kind of framework we need going into the 21st century and beyond?

Secretary GEITHNER. I think, Senator, this framework will meet that test. I mean, it is designed to make sure we are looking forward, not just solving the core problems of this crisis. So we are trying to design a framework that has that capacity, that is flexible in the future, and we made the judgment that—you know, we are proposing—we are proposing for your consideration, we made the judgment that much more substantial changes to force much more consolidation in our oversight structure, although it has much appeal, is not necessary and would not necessarily provide substantial return in addressing the core vulnerabilities in our system.

Senator TESTER. I look at this from the outside because I am not from the banking industry or the insurance industry or any part of either one of them. But I can tell you some of the concerns brought up by the Chairman and the Ranking Member about gaps and overlap, I still have concerns with this proposal. And I commend you for the combination of the OTS and OCC. I will give you another one that I think could and should be combined, and I want to know why not if just for turf, and that is SEC and CFTC.

Secretary GEITHNER. Excellent question. The Congress has considered many times in the past proposals for merging both entities. There is a simple, compelling rationale for doing that. What we are proposing, though, is to begin by bringing the underlying statutes, which are very substantially different, even for products that have very similar attributes, to bring those underlying statutes more into conformity. We think that helps solve most of the substantive problems that exist by having separate regulation of securities and futures. It will not solve all those problems. But it is a necessary step toward any effort to merge anyway, and so we think that is a good place, a good challenge to take on right now.

Senator TESTER. So do you anticipate into the future having a recommendation to merge those two agencies?

Secretary GEITHNER. I do not anticipate that now, but that is something, again, the Congress has considered many times in the past, and I would expect it to be part of what Congress would reflect on now.

Senator TESTER. With some leadership from your office?

Secretary GEITHNER. With appropriate leadership, suggestions, help, persuasion, analysis from our office.

Senator TESTER. Thank you. Accountability—I think it is absolutely critical. It has been brought up here with many of the questions that have been brought up with my fellow Senators here. I think—and correct me, and I hope you can. I think there are still gaps in accountability, holding people's feet to the fire that are there to do their job that, quite frankly, are either pushing it off on somebody else because we have a patchwork system or buffaloing somebody because they are not doing their job.

Can you tell me how this plan improves accountability to a point where we can reinstate consumer confidence in the marketplace that they are being protected?

Secretary GEITHNER. We are trying to do two difficult things. One is to make sure there is much clearer accountability, matched with authority, in the areas that are critical to building a more stable, stronger system, and those areas are market integrity, investor protection, combined responsibility now of the CFTC and SEC; consumer protection; supervision of banks; resolution authority; and the ability to deal with systemic threats to the system, which we are investing—proposing to invest more clearly with the Fed.

That will not close all gaps in the system, but those are the core functional responsibilities of policy in any financial system.

Now, to make sure that we take an integrated look at the system as a whole, to make sure the system has the capacity to evolve in the future, we are going to establish this council with a mandate to play that basic role, and the council will have the ability to make recommendations for changes by the underlying functional supervisors where there are gaps and problems, boundaries, conflicts, overlap in that context.

Now, Senator, we are not proposing an elegant, neat structure. We are not proposing to put together all those functions. I would just say in part because if you look at other countries that have done that, I do not believe you can show sufficient improvements in outcomes in building a more stable system. Many of the countries that adopted a much more streamlined, simplified regulatory system still got themselves in the position where their banking system grew to a point where it is much, much larger relative to the economy than happened in the United States. Our banks are roughly one times GDP now, even with the investment banks now as bank holding companies. In many of the major economies in Europe, banking systems got to the point where they were 2, 3, 4, 5, 8 times GDP in Switzerland, even with neat consolidations, more elegant appearing, simple accountability.

So the core thing to making the system more stable is getting the rules better, smarter, to induce thicker cushions, better shock absorbers, better able to withstand risk.

Senator TESTER. My time is up. I look forward to working with you on these issues as we go forward. I am not sure that the accountability is there for actually getting rough with folks, but I appreciate—and I mean this. I appreciate your bringing forth an initiative that we can sit down and have an honest discussion about how to move this forward.

Thank you very much.

Senator JOHNSON. Senator Johanns.

Senator JOHANNS. Mr. Chairman, thank you. And, Mr. Secretary, thanks for being here today. Your proposal I do think gives us some things to consider and debate, and I think your testimony has been very, very thoughtful. But I, like so many of my colleagues, do have some concerns.

Let me, if I could, start with some comments that my colleague Senator Warner made about the economy. We certainly cannot dispute the fact that the market is better. We can look at some other things. Certainly it is painful for all of us to see unemployment going up. It does not show any signs of subsiding at the moment. That hurts real people.

We are on this just historic spending spree that I think just grows exponentially. You were in China recently. I have worked with China as a Cabinet member. I remember the many times China, when I wanted to talk about them opening their market to beef, they wanted to remind me of how much debt they had bought the week before. I think that puts us in a very precarious position.

To use very inartful terminology, I really worry today if what we are seeing is kind of a dead cat bounce where all we are doing is pushing so much borrowed liquidity into our marketplace that we are just setting ourselves up for the next cliff.

So I wanted to say that because I think our debt, our spending, our taxing, all of that is a very, very troublesome trend, especially as we are starting to think about a whole new initiative to spend over a trillion dollars, the health care initiative.

But let me focus in on your proposal. The issue with the Fed I think is really a fundamental issue, and I can argue it from a lot of different directions about how uncomfortable I am to see the Fed get in the middle of this.

On the one hand, I must admit, although some of my colleagues on this side of the aisle would probably argue with me, the independence of the Fed has served us well over time. I really believe that. I have watched Presidents avoid criticizing the Fed as interest rates went up and this and that, so that independence I think is a good thing.

The more we entangle them in managing systematic risk or overseeing systematic risk, *et cetera,* the more we are going to be tempted—maybe not us so much, but the next generation, the next generation of Congress, the more the temptation is going to be to demand that oversight—justifiably so, I might add—then all of a sudden the independence I believe starts to go away.

I would like to hear your thoughts on that issue, and then I would also like your thoughts on—on page 3 of your proposal, you talk about the Financial Services Oversight Council dealing with identifying emerging systemic risk and then the new authority of the Federal Reserve. Was it your attempt there to try to blend maybe the idea of this collegial oversight of systemic risk with the Federal Reserve actually being a regulator here? Talk us through that, because I find that to be an interesting concept, actually.

Secretary GEITHNER. Senator, let me just begin by saying you are right to underscore the risk we still face in the economy going forward. You know, what we have achieved is some stabilization. Output and demand are no longer falling at the same pace it was at the end of last year. That is an important beginning. But it is just

a beginning. There are substantial risks ahead. And I think you are absolutely right that a critical part of getting a recovery in place is going to be to convince the American people and investors around the world that we are going to have the will, working with the Congress to bring those deficits down over time. But, remember, we started with deficits in the range of 10 percent of GDP when the administration came into office because of both the cost of the crisis and the impact of policies put in place the last 8 years, and the additions we have made—we have proposed with the Congress to get us out of recession were modest increments to those deficits, and we believe they were necessary to avoid the risk of a deeper recession, and even higher future deficits. But I understand those concerns, and we share those concerns. It will be absolutely critical to get our fiscal position down to a sustainable position once we get recovery back on track.

In terms of the Fed, I think I just would say it this way: We are very committed and it is very important that we preserve the independence of the Fed and its basic credibility over its responsibilities for monetary policy. And we would not recommend proposals that would limit that flexibility or put that at risk in some sense because that is important to any effort to build a well-functioning economy in the future. If we lose that credibility, that would be very damaging.

So I share that concern very much, and we have been very careful not to create risk. In fact, as I said, some of the proposals we are making to scale back and limit are designed to reduce the risk that in carrying out its core financial stability functions we do not put them in the position where it would risk greater tensions with that core mandate for price stability and sustainable growth in the future.

You are right, and the council does try to strike a balance. The council does bring together at one place around one table with clear responsibility for looking at the system as a whole. Each of these underpinning parts of the system we are preserving do have responsibility because I think they could cause systemic damage. That is an important check and balance in some sense on the scope of independence, without confusing accountability. I think it does not change their statutory framework. It does not qualify their authority in that context, but it does provide the ability to recommend and induce changes if they are behind the curve or their big gaps are not closing.

So we are trying to get that balance right. I agree some people will say it is too weak, but we do not believe we could give a council the authority and the accountability for doing core supervision, for example, of large institutions or for responding to crises given the speed with which they can evolve.

Senator JOHANNS. Mr. Chairman, thank you very much, and, again, Mr. Secretary, thanks for giving us this starting point here.

Senator JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. Secretary, thank you for your service and particularly at incredibly challenging times. You know, I have heard some of the criticisms already leveled, and while I do not agree with every element, I think it is a great foundation, actually. But I think it takes

a pretty short memory to ignore what got us into this crisis and dismiss the need for accountability. That is basically like saying let us do this all over in 10 years again, and I do not think the American people want to go down that road. So I appreciate the effort here.

You know, throughout these hearings, I have asked a fundamental question—at least for me it is a fundamental question. If we have institutions that are too big to fail, have we not failed already because they create systemic risk, and they also leave for potentially bad decisions along the way because they know that they will ultimately be bailed out?

So I saw the road that you have traveled here in trying to, I think, deal with that question with reference to increased capital requirements, but is that really sufficient to get to the heart of that question? You know, I understand bringing up those capital requirements now, but how is it going to be a continuing function so that we ensure that if that is one of our major vehicles to avoid too big to fail, that it will be a constant movement that will ensure us that that is a break on that possibility?

Secretary GEITHNER. Senator, again, this is a critical issue. Again, I think the acid test or the critical test of credibility of any system is: Is it strong enough to withstand the pressures that could come with a failure of a large institution? Because if you do not build the system strong enough to withstand those pressures, then the Government will be forced over time in future crises to intervene to prevent their failure, and that will create the risk of greater crises in the future. So that is critical to the objective of what we are trying to achieve.

I believe the best way to do that and the really only effective way to do that is, again, to make sure there are tougher constraints on leverage and risk taking in the future, applied not just to every institution that is a bank does those—takes those kind of risks, but to the largest in particular; that the core markets where institutions come together to transact also have thicker safeguards, thicker cushions to prevent the contagion that can be caused by default of a major institution, and to have better tools for managing an orderly failure of a large institution through resolution authority.

I think that mix of proposals I think represents the best hope of limiting the moral hazard risk that comes from any modern financial system where you can have some institutions whose role in markets by definition is so important that, if they get in trouble, it is going to risk undermining the broader health of the economy as a whole.

So I think that is the best mix. A lot of people, a lot of thoughtful people have ideas in this area. We will be open to ideas, and we will look at whatever we think the best balance of proposals are to deal with that challenge.

Senator MENENDEZ. You know, one of the things you propose and some of my colleagues have already raised is the oversight council, and I think that has a valuable function in watching for developments that pose risk to the banking system and better coordinating the regulators. My concern, again, is that it is basically advisory and it has no power to carry out corrective actions that will be needed in response to the council's own findings.

So give me a sense of how do you envision—so the council comes up with a series of findings that say, hey, this poses risk. What happens if an individual regulatory agency disagrees? What happens when, in fact, the council's conclusion that a particular product or activity poses a risk to the financial system, how is the corrective action going to be both considered and acted upon if it is only advisory at the end of the day?

Secretary GEITHNER. You are right. That goes to the core of the basic judgment we are making. We are giving the council the power to collect information, the responsibility to look across the system, and the power to recommend changes, but not the power to compel or force changes because that would fundamentally change and qualify the underlying statutory responsibilities of those agencies and I think that would create the risk of more confusion and less accountability, frankly. But that is a difficult balance to get. I am not sure we have got the balance perfect, but I think that to invest in a committee responsibility to force those kind of changes would, I think, lead to more diffusion of accountability and more uncertainty.

Senator MENENDEZ. But under your proposal, you give the Federal Reserve significantly, for example, significantly more authority, yet the reality is they had knowledge and authority to address the mortgage problem long before it became a crisis and they didn't act. And so in my mind, how is it that we ensure that at the end of the day, the regulators do their job, because from my perspective, they were asleep at the switch instead of being the cop on the beat. So how do we ensure that in this policy?

Secretary GEITHNER. Well, that is an important responsibility of the Congress. This council does bring them together. It does have to provide reports to the Congress. Its recommendations will be public. That gives you a little more reinforcement in carrying out their oversight responsibility and I think that is worth doing.

Will it—it will not—I cannot tell you, standing here today, and say it will prevent all regulatory failures in the future, and there may be issues in the future where we fail to adapt quickly enough. But it is a substantially better structure than we have today and I think it is a better balance of authority and accountability than an alternative model that would give the council the ability to override qualified change fundamentally the existing statutory responsibilities of those agencies. I think that would be confusing, confusing to the markets, and it would lead to more of this going on.

Senator MENENDEZ. Mr. Chairman, I know my time is up. I look forward to working with you. I have some suggestions and I look forward to working with you as we move forward. Thank you.

Senator JOHNSON. Senator Martinez.

Senator MARTINEZ. Thank you, Mr. Chairman.

Secretary, thank you for being here and thank you for the hard work you have been undertaking in the many months you have been on the job. I have a question about this whole notion of systemic risk. In the past, we saw the government-sponsored enterprises, that they, in fact, had an implicit, which became explicit, government guarantee. By doing so, they were able to borrow at cheaper rates. As they borrowed cheaper than the private sector, they essentially squeezed out competition, grew larger. As they

grew larger, their risk to the economy became systemic. They grew yet larger. Competition went further away. And they are, as we have discussed here earlier already, a key component of what went wrong with our system.

How do we not come right back into this in a broader sector of the economy—this was just securitized mortgages—but doing the same thing now in insurance, in other financial services, *et cetera,* by creating a group of entities that are too big to fail, therefore having an implied guarantee from the government, therefore being able to borrow cheaper money?

Secretary GEITHNER. Excellent question and a core concern that shaped our recommendations. Just to go back to where you started on the GSEs, remember, these institutions were allowed to operate with this implicit guarantee. As you said, lower borrowing costs take on a huge amount of leverage. They were not subjected to remotely conservative—sufficiently conservative capital requirements and there was no mechanism established in the law for dealing with their potential failure.

Congress created, at least laid a foundation for fixing both those problems in the legislation it passed last year. That is a beginning, but it is only a beginning. As I said to one of your colleagues earlier, we are going to have to come—we are going to make recommendations once we get through this proposing what we do with those institutions in the future.

What we are proposing for the rest of the system is based on that lesson, in many ways, which is stronger, more conservative capital requirements where there is the risk of moral hazard in the system and a resolution authority that gives us the capacity for managing failure. Those are the two critical things to do and our core responsibility, I think, is to do those key things and that will help mitigate the risk that you referred to which we, of course, are deeply concerned by, that the actions that we have created and that we have taken in this crisis to contain the damage will sow the seeds of future crisis by leading people to believe they will be insulated from the cost of future mistakes.

Again, the best protection against that is to make the system safe for failure in the future, reduce the risk of large pockets of excess leverage with conservative capital requirements, and better tools for managing failure, orchestrating an orderly unwinding of a large, complex institution in the future.

Senator MARTINEZ. I still don't know how we will avoid the—and I agree with you completely that the GSEs were well undercapitalized, underregulated, and there was no plan for their dissolution. However, how do not a group of companies become then those that are too big to fail, which in turn allows them to borrow cheaper money? I mean, once the risk of failure is diminished by government backing, implicit that becomes explicit, aren't they in a position to borrow cheaper and therefore squeeze out competition from those who are not considered systemically important?

Secretary GEITHNER. That challenge is at the heart of bank regulation. With the establishment of deposit insurance, with access by banks to borrow from the Fed against collateral, you do create the risk. You do create a lower borrowing cost and you create the risk

that there is an implicit support from the government coming in crisis.

The only ways we know to counteract that risk are to make sure there is strong oversight, a consolidated basis, more conservative capital requirements, and better capacity to let institutions fail when they get themselves to the point where they have managed themselves to the point of vulnerability. I am not trying to oversimplify it, but if we don't get those two things right, nothing is possible and they will get us a substantial distance to the point where we are limiting the moral hazard created by the role they play in the system.

Senator MARTINEZ. On the GSEs' future, I just wanted to find out from you what your thoughts were in terms of when this consultation process might conclude and would the FHFA be involved in this process? I presume they would be. In other words, who will be the coordinating council or whatever this group is going to be called that is going to analyze and study and make recommendations on the GSEs and what opportunity will there be to comment, for people to participate, *et cetera*?

Secretary GEITHNER. To be honest, Senator, we have not designed yet the full details of the process we think would be helpful in terms of exploring all alternatives. But we will involve the FHFA and Department of Housing and Urban Development. Treasury will coordinate the process. We will consult not just with this Committee, but with your counterparts in the House, and we will try to consult broadly in the markets and the academic community as we think through broad options.

I actually can't recall what we proposed in the paper in terms of a timeframe, but I think it would be reasonable for us to start to bring forward recommendations and options sometime in the first half of next year.

Senator MARTINEZ. Thank you, Mr. Chairman.

Senator JOHNSON. Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman.

Mr. Secretary, it is good to see you. Thank you for your efforts here.

Over the last 5 months or 6 months or whatever it has been, what I have discovered is that with respect to the Federal intervention in the immediate crisis, I think it is fair to say there is very little consensus about the details of that or about it as a whole, and I know that presents a huge struggle for you and for the administration because everybody is a critic but not everybody has to come up with a solution and I think you have worked hard to try to get through a lot of this. I think there is also limited consensus still about what we ought to do to fix the problem we have got prospectively.

What people have come to understand is that we have come out of a decade where our savings rate as consumers dropped to zero, the Federal debt ballooned from $5 trillion to $10 trillion, and banks or financial institutions on Wall Street that historically have been levered at 12 times were levered at 25 and 30 times, all of which, as you said in your testimony at the beginning, when it all came crashing down has left our families in an unbelievably vul-

nerable position—jobs lost, houses lost, college educations deferred for people all over my State and all over the country.

And I know that we are designing this prospectively, but for the folks watching this at home, if we could rewind the movie that we just had play out of a period of an absurd amount of leverage in our economy, of risky decisions that should never have been made by people that should have been known better, of risks that were taken actually in plain sight but we missed it, all of us, in part because of the way our regulatory system was designed, as you rewind that movie in your head, looking back, let us imagine that the regime that is being proposed was in place and how would things have been different as a result of that?

Secretary GEITHNER. If what we are proposing today had been in place, it is—banks would not have taken on so much risk. Institutions that were not regulated as banks would not have been permitted to take on that level of risk. Consumers would have been less vulnerable to the kind of predation that we saw, particularly in mortgage products, and the government would have had the ability to act earlier, more swiftly, to contain the damage posed by the inevitable pressures that come when firms fail. You know, again, we want a system where innovation can happen, when firms can fail, where investors are accountable for the risks they take in some sense, but you have to create a system that is strong enough to allow that to happen.

So that is a simple way to say banks would not have been able to take on this much risk. You wouldn't see this much risk buildup, leverage buildup outside the banking system to a point where it would threaten the stability of the system. And consumers would have been less vulnerable to the kind of predation we saw, and the government would have been able to act sooner.

Senator BENNET. In sort of the combination of the council versus the Fed versus the Consumer Protection Agency and all this, who would have detected that we have got these things out here called credit default swaps that are mounting on the balance sheets of our banks and that is a cause for concern, and to whom would they have communicated that and what action would have been taken as a result?

Secretary GEITHNER. They were a bit of an orphan in the current structure. But under this regime, we are giving the SEC and the CFTC much more explicit authority. We are pushing the standardized piece of those products onto central clearinghouses, onto exchanges and transparent electronic trading platforms and giving the SEC better authority to deal with potential manipulation and fraud in those areas. That would have helped. If they were behind the curve and failed to act in that context, then the council would have the ability and the authority to bring that to light and to urge them to fix that problem.

So I believe under this model, you are going to have the Secretary of the Treasury doing something I don't believe you have ever asked the Secretary of the Treasury to do, which is to come before the Congress on a regular basis and report on evolution of risk in the system and whether the overall system as a whole is doing an adequate job of responding to those risks.

Now, we won't have the full authority that Congress has given to the underlying regulatory agency. They will each have a piece of responsibility for that. But in some sense, you will be able to look to the executive branch to say, does the whole thing work? Are we dealing with gaps? Are we adapting to emerging risks? And I think that will be a substantial improvement.

Senator BENNET. And then—Mr. Chairman, one more question—and then if all that left us in the position where an institution that was a bank holding company found itself in crisis, we then have a new approach to resolution authority, as well, that you are proposing.

Secretary GEITHNER. We would. We would have a capacity to act earlier, I think more effectively, possibly at less cost to the taxpayer to contain the damage to the economy from that kind of specific challenge.

Senator BENNET. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

Senator JOHNSON. Senator Corker.

Senator CORKER. Mr. Chairman, Mr. Secretary, always good to see you. Thank you for your service.

Secretary GEITHNER. I am not Mr. Chairman yet, but I——

Senator CORKER. You know, I read parts of this proposal and I almost imagined a couple of folks sitting around at the White House drinking Diet Cokes, and especially when a lot of the heavy lifting wasn't addressed, the GSEs and CFTC and the SEC, only portions were addressed, and I think numbers of people on both sides of the aisle have alluded to that. And yet I saw that the Fed was a clear winner in this. I think everybody on this panel would agree with that.

This administration has received accolades in some quarters for trying to make sure there are no conflicts of interests and lobbyists can't be hired and all that. I wonder if it would make sense, since there will be a lot of interaction with you guys and obviously there will be some arm twisting and consultations taking place, I am sure—would it make sense for the President to, in writing, tell all of us that no one involved in creating this at the White House or cabinet will be appointed as Fed Secretary, or Fed Chairman?

Secretary GEITHNER. No, I don't think that would be appropriate, nor do I think it would be necessary.

Senator CORKER. It is interesting to look at the new——

Secretary GEITHNER. I think you expected that answer, Senator.

Senator CORKER. I actually expected that—I don't know. I think it would be good for us to know as we move through that none of the folks involved in helping create these new powers under the Fed are potential Fed Chairmen. I think that would be good to know. But I will leave that to you all.

Let me just move on. The resolution authority, you and I have talked about this since the very first time you came up here. It seems to me that what you are doing is, in essence, making TARP exist in perpetuity. I know that you have the authority to actually cause organizations to not exist, but you also hold upon yourself the ability to do exactly what is happening in TARP today. I think most of us don't like that much. I think most of us would like to see that end.

I know you were asked earlier whether you were going to extend it. And I just wonder, you know, the *ad hoc* nature of what has occurred, I think is what has created much of the instability, and yet you resume under yourself under this resolution, the power—the ability to do exactly what is taking place under TARP and I am just wondering why that makes much sense and not going ahead and having something that is very clear cut. Some people have talked about a special bankruptcy court. Some people have talked about the FDIC resolving. But you, in essence, are reserving to yourself the ability to cause TARP to go on into the future.

Secretary GEITHNER. No, Senator. I know you have said that many times, but it is not true and we wouldn't do that. TARP is temporary. It will be temporary. It will, fortunately, go out of existence when the statute expires, and maybe before that.

What we are proposing is to take this model that the FDIC has presided over, its existing checks and balances, its existing authorities, designed for a different financial system than we have today, and adapt it to bank holding companies and those complex institutions that present similar risks to banks. So we are doing the essentially pragmatic, conservative thing in taking a model that exists, has a lot of experience, has good checks and balances, and adapting to the financial system we face today.

We are not proposing to sustain some indefinite capacity to do what Congress authorized on a temporary basis—appropriately so—under the TARP. And I would share your concerns, any concerns people express with that kind of authority.

Senator CORKER. So you would work with us to make sure that you didn't have the ability just to conserve into the future and make *ad hoc* decisions at Treasury regarding entities that were deemed to fail?

Secretary GEITHNER. Well, again, Senator, the way the FDIC mechanism works today, and we are preserving that basic balance, any action would require a vote by a majority of the Board of the FDIC, a majority of the Governors of the Board of Governors of the Federal Reserve System, and the concurrence of the Secretary of the Treasury, and institutions that have banks at their center. Again, we are preserving that basic balance. There is a carefully designed set of statutory criteria for exercising that authority which we think fundamentally we can replicate in this context. So I think that has a—again, it has an established record, good, well understood checks and balances, a lot of merit in replicating that basic structure.

Senator CORKER. I know my time is up and I know we are going to be talking about this a lot more. The one thing that was interesting, I looked at—you know, the 13(3) issue has been raised a couple of times and that jumped out. It is interesting, and I think a lot of people have asked sort of the questions about priorities. You know, the Fed, a lot of people think, and I am not necessarily in every one of these camps, but some people think that the Fed earlier on failed with monetary policy and helped create a bubble. Some people think the Fed actually failed somewhat supervisorally. And yet they did a pretty good job responding quickly to an emergency.

And what you all have done here is actually sort of hamstrung them as it relates to dealing with an emergency, but yet on the other hand given them even greater supervisory authority. So it is just an interesting way that you all have gone about this and very different than what history has shown to be good practices at the Fed itself.

Secretary GEITHNER. I agree with some of what you said, and I particularly agree that the Fed, I think, in being able to move as quickly as it did played a decisive role in avoiding a much more catastrophic outcome for the financial system and the economy and I think we need to preserve that authority.

Now, what 13(3) does is to give the Fed the ability to lend to institutions it does not supervise, as I said. We are trying to fix that basic imbalance between institutions that play a critical role in markets and those that come under the Fed's basic supervision. By changing the authorities of that authority, we will reduce the risk in the future, particularly if you give us resolution authority. It will reduce the risk the Fed has to use 13(3) in the future to lend to institutions outside that basic framework of protection.

But as I said, even in this crisis, where the Fed acted, I think, very swiftly and effectively to help contain the damage, where it used 13(3) in particular cases with individual institutions, it did ask for the explicit concurrence of the Secretary of the Treasury in recognition again of the potential losses to the taxpayer that were inherent in those judgments, and I think that was appropriate for the Fed to do. As you know, I was closely involved in that decision and I think that those decisions—and I think that would be appropriate to put in place in the future. And I do not believe, but I think this is an important concern, that that would constrain the Fed's ability in the future.

Now, it is necessary, though, to tighten up the responsibility and authority the Fed has now for those core institutions, for payment systems because of the risk they present, and for capital. I think in those three areas, the Fed's authority is too qualified now. It has got responsibility without clear authority and accountability and I think that is worth fixing, basic pragmatic case for fixing that.

Senator JOHNSON. The Secretary must leave at noon, so I remind Members to abide by the 5-minute rule.

Senator Reed.

Senator REED. Thank you very much, Mr. Chairman.

Thank you, Mr. Secretary. Senator Warner also brought up the issue of the warrants and the guidance, and another issue which is on your long, long list to do is private equity involvement in resolutions of failed institutions, and any guidance, we would appreciate it at your earliest convenience.

Let me raise the issue which is going to be debated substantively for a long time, which is the Federal Reserve role, *et cetera*. You have suggested, I think, in an earlier answer, that the Fed would by October essentially report back to us about the changes that they have to make to accommodate these new responsibilities. So what are we doing between now and October in terms of moving this debate along, if we have to wait for the Fed to sort of say, well, this is how we are going to do it?

Secretary GEITHNER. I don't think you need to wait for the Fed on that to proceed with the legislative process on design. There is the specific set of questions around how to deal with some of the concerns Senator Shelby and others raised about the role of the Reserve Bank Boards, the set of firewalls and constraints that prevent involvement of Federal Reserve Bank Boards in supervision, a range of things like that where we think it would be appropriate for the Fed to try to clarify, bring recommendations for how to tighten up those kind of safeguards and constraints, and I think that can happen on that path without getting in the way of your efforts to consider legislation.

I know the Chairman is considering coming together, and will be happy, I am sure, to come before the Committee and talk about what role they think the Fed should play in looking at systemic risk and how to respond to the concerns many of you raised that that not distract them from their core responsibilities for monetary policy.

Senator REED. You know, my sense is that with these new responsibilities, there has to come not only new organizational arrangements, which we would like to, I guess, have them suggest what their recommendations are, and then second, I think, is even the issue of culture. That is this issue of is it safety and soundness trumps everything else? I think also, too, in terms of transparency, one of the—my sense from talking in hearings and just generally is that, you know, there were rather vigorous debates in the Fed about is there a housing bubble, is there not a housing bubble, were savings rates too low, *et cetera.* That never got out.

How do we have an agency that is going to be transparent in terms of these issues? Similarly, will there be an independent analytical staff? Will there be someone charged, not just at the Board, but a Deputy for Systemic Regulation that may or may not be subject to the confirmation process? And then this raises the bigger issue which many of my colleagues have talked about is just oversight. Ultimately, they are imposing legislation. I can recall, along with many others, writing several letters, I think, to the Fed about one of these HOEPA regulations coming out.

So these are critical issues and I wonder if you could just comment briefly.

Secretary GEITHNER. I think you are right that they are important questions and you have relayed a number of important suggestions about how the basic structure may need to adapt, and I think the best way to deal with these is to work through them together with the Fed. Again, we suggest that the Fed start to think through about what they would propose in that area for consideration by the Committee and I don't see any reason why that process can't move quickly.

Senator REED. Let me just add another issue, too, that will be part of this debate about whether the principal systemic regulator is the Fed or a committee. FDIC is run by a committee, I think. Frankly, aren't you on it?

Secretary GEITHNER. I am not on the Board of the FDIC, but the head of the OTS and the head of the OCC are.

Senator REED. The OCC. Thank you, Mr. Secretary. But they seem to do a pretty good job about supervision and also resolution and other things. Does that argue for——

Secretary GEITHNER. I think you are exactly right. I think you—in some ways, the ideal institution has a strong, independent, professional, experienced, competent staff of experienced people, a strong executive accountable, and a board that can provide a broader framework of oversight. I think that basic model can work. But I think that is different from investing a council with formal statutory authorities to change and compel judgments by independent agencies that have a different set of statutory responsibilities. I think that is the difference I would make.

Senator REED. I am going to abide by the Chairman's admonition to stay within 5 minutes, but just one final very quick comment. That is, I understand your proposal does include registration of advisors to hedge funds, which is legislation that I proposed and I think it is on the right track and we would like to work with you. Thank you.

Secretary GEITHNER. Absolutely.

Senator JOHNSON. Senator Hutchison.

Senator HUTCHISON. Thank you, Mr. Chairman.

Mr. Secretary, first, I want to say that I think you have been very thoughtful and forthcoming today and I am not yet ready to say that I am going to give the Fed this new power, but I think the points you made in your first answer were very compelling so I want to—I am conflicted about the independence, which I think has served us so well through the years, but yet the potential compromising of that by going into more regulation.

Second, I think that your proposal is attempting to do something that is good. I am not sure when the devilish details come out that it will be so. But trying to level the playing field between banks and S&Ls surely was one of your purposes and also streamlining the whole oversight of that. But I think S&Ls have had a special place in our country and I want to make sure that we still have the services that they have been so able to give, which really started out being mortgages but evolved into more.

I also want to make the point that I agree with Senator Schumer, who said something earlier today that was said to me by one of the great bankers in our State, Tom Frost, who is also now the biggest independent banker and has been very successful with the Frost Bank. And he said as long as you do not require a person who originates a mortgage to keep part of it, you are going to have problems. And I think keeping a part of it in the originator is a very important concept that we need to incorporate into a reform, plus, of course, servicers and second servicers and how many iterations of that they have. I think we need to have skin in the game, as it is described, for everyone that is connected with a mortgage going forward.

I want to switch just for a moment for my question on TARP, and that is to say that every one of us who was here last fall feels that we were misled by the original intention of the Troubled Asset Relief Program, which was to take the money to buy troubled assets in banks to stabilize the banking industry. Last year, that was proliferating into other areas, and it has continued in your admin-

istration as well. So we now have 11 different programs, none of which is buying assets of banks that are troubled.

So my question is this—as Senator Bunning mentioned, you will be able to sign a paper and extend TARP for 10 months at the end of this year, and you said you were not sure if you were going to. This is my question: Do you believe that these 11 funds that have been a part of TARP that were not all a part of the original purpose of TARP should have more congressional oversight? Because I am looking at introducing legislation that would provide that. And if so, do you think it would be wise for Congress to be able to vote on all of the 11 new programs? Or if not, what do you think would be the proper role of Congress? Because I am not comfortable with having been misled last year, then currently going for 10 months and then—well, actually about 6 or 7 months, plus another year in something that seems to have no congressional oversight.

Secretary GEITHNER. Senator, at the beginning of this administration, we said that there were five areas where we thought it was going to be appropriate to consider using TARP authority Congress provided, and those were to help address the housing crisis, to make sure banks have capital where they need capital, to help support bringing back the securitization markets, targeted programs for small business lending, and a program to help restart these markets for loans on the balance sheets of banks.

Now, we have moved forward to put in place programs in each of those areas, as we said we would do. We are on the verge of putting in place the last of those programs, which is to help create a set of funds to help restart these markets for—you call them "toxic." We call them "legacy assets."

These programs are subjected to an enormous amount of carefully designed oversight, not just by the Congressional Oversight Panel you provided, you established under statute, but also by a Special Inspector General at the Treasury and by the GAO. They report monthly on everything we are doing.

We have been fully transparent about the specific terms underpinning each of these programs so that everyone can look at exactly what we are doing and measure their impact and their success. We are looking very carefully at every recommendation those oversight bodies make for bringing more transparency and accountability to them, and where we think they make sense and we can do them, we have adapted those recommendations, and we will keep doing that.

It is hard to know what might be necessary in the future in terms of using this authority, if any further use will be required, but my sense is that if we need to do more in the future, that anything we do will fall within those core basic framework, which, to reduce them, are about making sure the banking system has capital and making sure these markets are getting going again.

Senator HUTCHISON. So further congressional oversight would not be necessary or prudent, in your view?

Secretary GEITHNER. Well, again, I think you have put in place an enormously powerful set of oversight mechanisms, and I think those have done a very good job of helping provide not just a second pair of eyes, but three additional sets of eyes looking over ev-

erything we do. Of course, we would be happy to look at ways to sort of strengthen accountability and transparency because it is important to our credibility, too. But I do not believe you need new legislation in this area.

Senator HUTCHISON. Thank you, Mr. Chairman.

Senator JOHNSON. We have time for one more question apiece. Senator Merkley.

Senator MERKLEY. Thank you very much, Senator Johnson. Am I limited to just a single question?

Senator JOHNSON. Yes.

Senator MERKLEY. Thank you, Mr. Chair.

I would like to praise the plan that you put forward, and three things that I had been advocating for were in the plan: the Consumer Financial Protection Agency, having a housing expert involved in the systemic risk council, and power to reform predatory retail mortgage practices. So I certainly appreciate those aspects having been addressed.

In regard to the Consumer Financial Protection Agency, would they have the power without additional input—or not input so much but authority from some other sector to do things such as shut down new tricks and traps introduced into credit cards or shut down new tricks and traps introduced into mortgage lending practices?

Secretary GEITHNER. Yes. Where those practices threaten basic standards of consumer protection, they would have that authority to set rules to constrain that and to enforce those rules.

Senator MERKLEY. Thank you.

Senator JOHNSON. Staff indicates that you may have your full 5 minutes.

Senator MERKLEY. Thank you. Thank you very much, Mr. Chair.

Well, I wanted to go on to ask, in terms of the power that would go to the Fed under this plan, I think I have a ways to go to see the Fed as the right place to set capital adequacy rules, in part because of the situation in the past, for example, they fought against keeping leverage ratios. Is that the right place to center this kind of power?

Secretary GEITHNER. I think so, because I think that if you give it to too many people, you do not have accountability for when you get it right. And I think that they have got the best incentives to make sure that those basic safeguards are strong enough to help us withstand future crises.

Senator MERKLEY. So let me frame it a little differently. We gave power to the Fed in the past that sat unused and unexercised in situations where, of course, with the power of hindsight—which is always much better than foresight—we would have wished they had exercised that power. Is there a way to have them address their role in monetary policy at the same time having them see this as a major mission, a major responsibility, and that they will not fall asleep at the switch?

Secretary GEITHNER. Senator, I think I need to just say one thing which is important to point out. If you look at the mortgage market in the United States where practices were worse, they were worse the greater distance you had from a Fed-supervised institution.

If you look at where the pockets of risk in the financial system were worse, where you had leverage go to the point where institutions were at the edge of the abyss, no longer could decide independently, like in the case of Countrywide, for example, and two of the world's largest investment bank, or if you look at AIG, those were institutions that the Fed had no ability to affect risk taking those institutions. So I do not think it is fair to say, looking at the record of performance of our system over this period of time—even though, as I said, everybody part of this system, there are areas where they could have done substantially better. But I do not believe either in the mortgage area or in the core things that threaten the stability of the system it is fair to say that where those things were most acute, they were institutions that were under the Fed's supervision. And I did not believe that the additional accountability and clarity of responsibility we are proposing to give the Fed, building on their existing responsibilities today, has any significant risk of undermining their capacity to keep growth stable, sustainable over time, and keep inflation low and stable in the future.

Senator MERKLEY. Well, I appreciate your response. I am not fully persuaded, but I do not pretend to be an expert in this area. But I will try to dive into it a little more and follow up with your team, and thank you very much.

Secretary GEITHNER. Again, I want to just say no part of the system acquitted itself particularly well, and everybody is going to have to do a better job in the future, and that is why we are proposing, among many things, a comprehensive assessment of the basic record of supervision across agencies in the U.S. responsible for that.

But we have to make choices going forward about how to build a stronger system, and what we have recommended, what the President recommended I think vests authority where it needs to be in institutions with the best capacity to discharge that responsibility well.

Senator MERKLEY. Well, thank you, and I will yield back the balance of my time, and I do feel like the administration has put forward a very strong proposal for us to work with. Thank you.

Senator JOHNSON. Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman. And, Mr. Secretary, thank you for being here. I want to indicate at the outset that I share a number of the concerns that have been raised by my colleagues here in reference to the new authorities to be given to the Fed. But since that has been gone over a lot, I want to in my short time focus on an issue that I do not think has had much attention here yet today, and that is the bifurcation of consumer protection from safety and soundness regulation.

It seems to me that we can get the most effective consumer protection by not bifurcating those two functions and moving forward in a way that allows those who are really connected with the regulatory system of our banks to have the ability to implement statutory and regulatory policy on consumer protection.

What I would like to do is to read you a statement by the Comptroller of the Currency, John Dugan, when he testified before our Committee in March, because he made the same points and made

a number of points about why that is the case, and I would like you to respond to his points. He says, “The best way to implement consumer protection regulation of banks, the best way to protect consumers, is to do so through the prudential supervision.” He gives these following reasons:

First, prudential supervisors’ continual presence in the banks through the examination process put them in the very best position to ensure compliance with consumer protection requirements established by statute and regulation;

Second, prudential supervisors’ have strong enforcement powers and exceptional leverage over bank management to achieve corrective action;

And, third, the examiners are continually exposed to practical effects of implementing consumer protection rules for bank customers. The prudential supervisory agency is in the best position to formulate and refine consumer protection regulations for the bank.

Could you respond to those points?

Secretary GEITHNER. Those are thoughtful concerns, and they have been made by supervisors in the United States for a long period of time, and we have had some experience with that model, and it did not work well enough. So our basic judgment is we need to change the model, and separating that responsibility from the core safety and soundness responsibility of bank supervisors is a better way to get a better balance on both those functions.

But you are right and that is a good version of those concerns that you quote from John Dugan, and I think those are good arguments. But I would just say we have had a good experiment in whether that model works, and it did not work well enough.

Senator CRAPO. So you are saying that we had adequate consumer protection statutory and regulatory authority, but that it was not exercised?

Secretary GEITHNER. No. I would say that there were limitations both in the strength of the rules that were established and how those were enforced. The rules themselves were probably, I think, almost certainly not sufficiently strong, and it is certain that they were not enforced with sufficient rigor and evenness across the range of institutions that allowed to generate those products.

Senator CRAPO. How do you respond to the concern, though, that one of the needs we have to focus on, at least in my opinion—and I think this is a pretty broadly held belief—is to streamline and make more efficient our regulatory system? Before we got into this crisis last October, you know, most of the focus on regulatory reform was on how to stop our slide in competitiveness with regard to our foreign capital markets or the world capital markets. And one of the concerns there was that we continue to have this increase in numbers of regulators to the point where we have double-digit regulators for any financial function, and here we are seeing a proposal once again to increase the number of regulatory agencies that will now be managing our financial economy.

Secretary GEITHNER. Well, on balance, we are not increasing the number of agencies. We are reducing the one important source of arbitrage and inefficiency, which is between a national bank and a national thrift charter. But you are right, we are proposing to

separate the consumer function from the existing safety and soundness function and the other authorities that have that and put it in once place with accountability for the reasons I said, which is the current model with a long record in it, and it did fail in important respects.

I believe that this basic concern about the competitiveness of our system remains a very important concern that has to guide everything we do. But I do believe our system will be stronger, more effective, more competitive, greater confidence—enjoy greater confidence around the world if we have better safeguards and protections, not just around disclosure, which is very important, where I think we still lead the world, but in terms of basic protections against stability.

Our system will not be competitive, our institutions will not be competitive if we have a system in the future that has been as vulnerable as ours had to period crises like this every 2 to 3 to 4 years.

Now, this is the first crisis we have had in a long time of this severity, but we have had a record over the last three decades where every 3 to 5 years we have had a shock of significant magnitude, and I think that does not make our system or our institutions competitive, and a better foundation to stability would be supportive of trying to make sure that our system remains in many ways the envy of the world in doing this core job of taking the savings of American investors and channeling them to where they can be best used in support of innovation, new ideas, growing companies.

Senator CRAPO. Thank you. My time is up. I would like to pursue this further with you, though.

Senator JOHNSON. Senator Bayh.

Senator BAYH. Thank you, Mr. Secretary. I would like to start off with a comment and then two questions.

First, my comment is I would like to thank you for your openness and the dialogue you have established with Members of this Committee. There was a comment made previously about the timing of briefings and that sort of thing. I was at the breakfast that you had a few weeks ago. It was bipartisan. You elicited comments from all of us. So I want to just go on the record as thanking you for that.

Second, I want to commend you on the work product you have produced here. Very difficult dilemmas to wrestle with. It seems to me you have struck the right balance here focusing on the core mission, putting off until later some things that are desirable, but perhaps can be left to another day.

That takes me to my question, the first of my two questions. I am concerned—and you alluded to this—that there were a number of causes of the crisis that we face right now, some macroeconomic in nature. I am concerned that your excellent work product will go for naught and that we will be overwhelmed once again in 5 years, 6 years, 7 years, in a ways we cannot anticipate if those are not dealt with. And I refer specifically to the imbalance of savings and consumption in the world.

As the crisis, God willing, appears to be abating, I simply do not see the willingness on the part of some countries to rethink their basic economic models. And so I would be interested in your com-

ment about—I am deeply concerned that we are going to see a recurrence of this if that is not dealt with, so I am interested in your comment about that. In particular, you know, on the savings side, I see Americans are beginning to save a little bit more. That harms consumption in the short run, but in the long run it is probably a prudent thing. But isn't it also true that one of the best ways to increase national savings is to get our deficit down? And I am concerned that if you look at the size of the deficit, this year and next year is understandable, but in the out-years it looks like it may be larger than GDP growth, that is a concerning thing.

So what about these macroeconomic factors and their ability to overwhelm this architecture if they are not addressed? That is number one.

Secretary GEITHNER. I think you are absolutely right. We share that concern, and I think that it is very important as we put in place the exceptional measures to try to address the crisis, that we don't lay the basis for reigniting those basic imbalances which, of course, are the problem.

Let me just try to take the encouraging side of that argument for a second. You are right, private savings now are significantly positive. They moved from modest negative to 5 percent, which is a good start. Historical levels before the last three decades were more in the 8 to 9 percent and may go that place over time, and that is a healthy development, although you are right, it does—it will slow the pace of recovery.

You are absolutely right that we have to bring the fiscal deficit down over time. The Government is going to have to spend substantially less relative to its resources over time, and the President, as you know, is deeply committed to that.

Our current account balance has now come down from a level that was approaching 7 percent of GDP to now below 3 percent of GDP. That is helpful and important.

I would say as consequential, I think there is a recognition, not just in China but in many countries around the world, that the U.S. consumer is not going to be able to leave the global economy out of this crisis, and you are seeing in the basic strategy of economic policy, including in China, a much greater attention to policies that will shift the sources of future growth to domestic demand and consumption and bringing about a transition from a less export- , less investment-intensive model of growth to one more relying on domestic demand. That would be healthy.

But we are at the beginning of that, but it has to start with a recognition. I think you are seeing that recognition, but I agree with you, without getting that world economy a more balanced foundation of growth, these protections, although necessary, could be overwhelmed in the future.

Senator BAYH. Well, I am glad that they recognize the need to transition to a different global economic balance. I hope they follow through once the crisis is abated because, as you know, the economic models they have pursued are there for a reason. They have worked pretty well for them up until now, and you do tend to have strong vested interests within those societies for maintaining the *status quo*. But it is just not going to work anymore, and we are

going to see a repetition of this unfortunate situation if that does not change.

My final question deals with regulatory arbitrage. You have dealt with that here domestically. My question is: What about global regulatory arbitrage? And just as an example, in the whole derivatives area we used to be told, well, we have got to deal with this. And then the counter argument was, well, they are just going to go to another country, the risky behavior will take place, but we will lose jobs and revenue, so it is a loss–loss.

How are we cooperating with other countries to avoid, you know, global regulatory arbitrage?

Secretary GEITHNER. A very important point, and as you know, that is a central piece of the proposals we are making. We think there needs to be a level playing field and higher standards globally if this is going to work; otherwise, our safeguards will be undermined, and our institutions will be less competitive.

We are trying a different approach this time. Rather than putting reforms in place here, which raise standards here, and then engaging in a long process of negotiations to get the world to come to those higher standards, we are going to try and do it in parallel from the beginning so we get more quickly to a better place and are not left with these big disparities where risk will shift where the regulatory standards are worse. And there is a very elaborate system of cooperation in place under the auspices of this new institution we call the Financial Stability Board that is designed to drive consensus and change on those core areas, capital, liquidity, resolution of large institutions going forward. It is a critical part, and we are going to—we should be able to report regularly on how much progress we are making as we put in place these reforms.

Senator BAYH. Thank you very much.

Senator JOHNSON. Senator Kohl.

Senator KOHL. Thanks very much, Mr. Chairman.

Secretary Geithner, earlier this year I asked the FDIC Chairwoman about the possible separation of safety and soundness, compliance exams, and consumer protection activities, and she replied, and I quote: "Placing consumer compliance examination activities in a separate organization apart from other supervisory responsibilities ultimately will limit the effectiveness of both programs. Over time," she said, "staff at both agencies would lose the expertise and understanding of how consumer protection and safe and sound conduct of a financial institution's business operations interrelate."

So how do you explain their objections as well as the objections at the OCC to what you have proposed before us today? Do you intend to work with them to remedy and alleviate their concerns?

Secretary GEITHNER. Absolutely, and I think that the Committee will have the opportunity to hear from all sides on this and from people with lots of experience on both sides. But I think I would just say what I said to one of your colleagues, which is that we have had a rather searing experience with the model that was built on integrating those two functions, and it did not work well enough. And a core part of what went wrong in our system was because of basic failures in consumer protection and in some parts of

safety and soundness capital regulation. And so I do not think the current model served us well enough, and it requires change.

But, of course, we want a system that is going to work better on both those fronts, and our objective is to try to make sure this new agency has the right degree of accountability and expertise to carry out these important functions for rule writing and enforcement of consumer protections effectively. But I think Commissioner Bair is a thoughtful advocate of those concerns, as is John Dugan and others, and, of course, we will listen carefully to those concerns because what we want to do is have a more effective model.

Senator KOHL. Thank you, Mr. Secretary.

Second, I would like to express similar concerns that were stated earlier by Senator Bennett about shifting industrial loan corporation charters to bank holding charters and the possible impact on access to consumer credit as well as possible unintended consequences that the changes may have on parent companies of ILCs. Are you sensitive to that. Do you expect that we can alleviate those problems?

Secretary GEITHNER. Again, we would like to work with you to try to address your concerns. You know, what we need to do—and I think we all share this obligation—is to make sure we do not leave gaps in the system that in the future could emerge as another source of ways to get around stronger safeguards applied to a bank. And what we do not want to do is allow institutions that do similar functions, create similar risks to the economy, to be able to operate outside the set of protections we try to put in place.

We had a kind of searing experience with getting that balance wrong, although I think it is fair to say that ILCs at the moment were not a principal source of that concern. But that kind of gap unevenness is a core vulnerability we need to address. But, of course, we will try to work with you to address your concerns in that area.

Senator KOHL. And you are not looking for unintended consequences. We anticipate them.

Secretary GEITHNER. In everything we do, we have to be careful that we are making the system stronger and not making it more vulnerable. And we try to be very careful and try to anticipate the potential adverse consequences of these changes. And, again, we want a system that can adapt in the future, because we will not have the foresight today to anticipate and deal with preemptively any potential source of a risk. We want a system that can adapt more flexibly in the future as our system evolves, as innovation proceeds.

Senator KOHL. Thank you.

Thank you so much, Mr. Chairman.

Senator JOHNSON. Thank you.

Mr. Secretary, I applaud your recommendation to create an Office of National Insurance in your reform proposal. Can you expand on other ways the Treasury envisions modernizing and improving our system of insurance regulation?

Secretary GEITHNER. Senator, we have laid out in this white paper a set of broad principles that we should guide policy as the Congress considers how to make sure we have a framework for insurance regulation in the future that allows us to have that com-

petitive, efficient, and stable market for insurance products. So with an entity established in the Treasury, with accountability for thinking about these things, building up expertise, and those broad set of principles, we think we can begin a process of thinking about broader reforms.

Senator JOHNSON. Does the administration agree that reinsurance has a good case for regulation at the Federal level rather than the State level? What about life insurance and property and casualty insurance?

Secretary GEITHNER. Senator, we have not made that judgment yet. There are a lot of thoughtful proposals out there for establishing the ability to have a Federal charter to engage in a range of financial products, insurance products. Some people would cast that license, that charter more narrowly. Some proposals would cast it very broadly. But we have not taken a view yet on what we think the ideal model is.

Senator JOHNSON. Thank you, Mr. Geithner, for your presence, Mr. Secretary. This hearing is adjourned.

Secretary GEITHNER. Thank you, Mr. Chairman.

[Whereupon, at 12:06 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Good morning. Thank you all for being here. I would like to welcome Secretary Geithner, who is here today to discuss the Administration's proposal to modernize the financial regulatory system. Mr. Secretary, we applaud your leadership on a very complex set of issues intended to restore confidence and stability in our financial system. I look forward to exploring the details of your plan and working with you and my colleagues on this truly historic endeavor.

In my home State of Connecticut and around the country, working men and women who did nothing wrong have watched this economy fall through the floor—taking with it jobs, homes, life savings, and the economic security that has always been the cherished promise of the American middle class. These folks are hurting, they are angry, they are worried. And they are wondering: who's looking out for me?

I've seen first-hand how hard people work in Connecticut to support their families and build financial security. I've seen how devastating this economic crisis has been for them. And I firmly believe that someone should have their backs.

So as we work together to rebuild and reform the regulatory structures whose failures led to this crisis, I will continue to insist that improving consumer protection be a first principle and an urgent priority. I welcome the Administration's adoption of this principle, and I'm pleased to see it reflected in the plans we'll be discussing today. At the center of this effort will be a new, independent consumer protection agency to protect Americans from poisonous financial products.

This is simple common sense. We don't allow toy companies to sell toys that could hurt our kids. We don't allow electronics companies to sell defective appliances. Why should a usurious payday loan be treated any differently than we'd treat an unsafe toy or a malfunctioning toaster? Why should an unscrupulous lender be allowed to dupe a borrower into a loan the lender knows can't be repaid? There's no excuse for allowing a financial services company to take advantage of American consumers by selling them dangerous financial products. Let's put a cop on that beat so that the spectacular failure of consumer protection at the root of this mess is never repeated.

We have been engaged in an examination of just what went wrong in the lead-up to this crisis ever since February 2007, when experts and regulators testified that poorly underwritten mortgages would create a tsunami of foreclosures. Those mortgages were securitized and sold around the world. The market is supposed to distribute risk, but because for years, no one was minding the store, these toxic assets served to amplify risks in our system.

Everything associated with these securities—the credit ratings applied to them, the solvency of the institutions holding them, and the creditworthiness of the underlying borrowers—became suspect. And as the financial system tried to pull back from these securities, it took down some of the country's most venerable institutions—firms that had survived world wars and the Great Depression—and wiped out over $6 trillion in household wealth since last fall.

Stronger consumer protection could have stopped this crisis before it started. Consumers who were sold subprime and exotic loans they couldn't afford to repay were, frankly, cheated. They should have been the canaries in the coal mine. But instead of heeding the warnings of many experts, regulators turned a blind eye. And it was regulatory neglect that allowed the crisis to spread to the point where the basic economic security of my constituents in Connecticut—including folks who'd never even heard of mortgage-backed securities—was threatened by the greed of some bad actors on Wall Street and the failure of our regulatory system.

To rebuild confidence in our financial system, both here at home and around the world, we must reconstruct our regulatory framework to ensure that our financial institutions are properly capitalized, regulated, and supervised. The institutions and products that make up our financial system must act to generate wealth, not destroy it.

In November, I announced five principles that would guide the Banking Committee's efforts.

First and foremost, regulators must be focused and empowered—aggressive watchdogs, rather than passive enablers of reckless practices.

Second, we have to remove the gaps and overlaps in our regulatory structure that have encouraged charter-shopping and a race to the bottom in an effort to win over bank and thrift "clients."

Third, we must ensure that any part of our financial system that poses system-wide risk is carefully and sensibly supervised. A firm "too-big-to-fail" is a firm too big to leave unmonitored.

Fourth, we can't have effective regulation without more transparency. Our economy has suffered from the lack of information about trillion-dollar markets and the migration of risks within them.

And, fifth, our actions must help America remain prosperous and competitive in the global marketplace.

These principles will guide my consideration of the plan you bring to the Committee today. Mr. Secretary, I believe that we can find common ground in a number of areas contained in your proposal. I want to thank you, Mr. Secretary, for your leadership on these issues, as well as for your willingness to consider different perspectives in forging your plan. I hope you will view this as a continuation of the dialogue you've had with Members of this Committee as we work together to shape a regulatory framework that will serve our country well through the 21st century.

I want to thank all of my colleagues on the Committee who have demonstrated a strong interest in this issue. Our continued, bipartisan collaboration will be critical to ensuring that we enact sound and needed reforms to put our financial system back on solid footing.

And I want to urge everyone to remember that, at the end of the day, the success of what we attempt will be measured by its effect on the borrower, the shareholder, the investor, the depositor, and consumers seeking not to attain extravagant wealth, but simply to grow a small business, pay for college, buy a home, and pass on something to their kids. That's the American Dream. That's what we've gathered here to restore.

Thank you.

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Thank you, Mr. Chairman, for holding today's hearing with Secretary Geithner to discuss the Administration's new proposal to restructure our Nation's financial services regulatory structure.

As we all know, Federal regulators were forced to make unpopular decisions last year based on the belief that weakened financial firms were so big and so interconnected that their failure would devastate the world economy. Our economy began to nosedive as we faced the worst recession since the Great Depression.

When the TARP bill came through Congress last year, I felt it did not go far enough to improve regulation. Instead, we sent companies the message that if they are bad actors, the government will step in and buy the assets that are dragging their companies down.

Many of these troubled firms were deemed "too-big-to-fail," and thus we bailed them out with tens of billions of dollars in taxpayer funds.

Yesterday, President Obama and his economic team announced some of the biggest regulatory changes to our financial system since the 1930s.

Overall, this is a very complicated task to reform and modernize the financial services regulatory structure. All reforms Congress considers must help prevent a repeat of the events of the past 9 months and must shift the burden away from the American taxpayer and to the financial institutions that were reckless.

While the devil is in the details, it appears that the President's plan will give regulators the teeth they need to do the job, but also the flexibility to make sure our economy grows.

Over the coming months, the Banking Committee will work closely with the Administration to develop legislation that should make the needed changes to our regulatory structure and clear the way for a stronger, brighter and more stable economic future. I look forward to your testimony, Secretary Geithner, as we learn more details about the Administration's proposal.

PREPARED STATEMENT OF SENATOR SHERROD BROWN

Thank you, Mr. Chairman, for convening this hearing on the President's plan to improve the regulatory structure of the Nation's financial services system.

Thank you, Secretary Geithner, for appearing before us today and for your hard work on this plan.

Let me say at the outset that I agree with the President that we must reform our Nation's financial regulatory system. Why? All you have to do is pick up a paper or turn on the television to learn about homes being lost, Americans losing their jobs because businesses can't get access to credit, and banks being shuttered.

I believe that one of our Nation's forefathers, James Madison, said it best when he wrote that "If men were angels, no government would be necessary."

Much has been said and written about how we got here, how we arrived at the point of needing a comprehensive overhaul of the financial system.

One way we got here is through the free-wheeling creation and sale of complex financial instruments that only a small percentage of the world understands. These instruments were largely based on bets that the mortgage market would reap huge gains indefinitely and funded by loans to homeowners and investors, who often did not fully understand their loan terms and in many cases could not afford them.

The other route we took involved the failure of those charged with ensuring the health of our banking and financial services sector. I am referring to the patchwork quilt of regulators on whom we have relied to ensure that our bank accounts are safe and that we can invest with the confidence that all risks have been fully disclosed.

My priorities for reform are the protection of consumers, investors, and jobs and ensuring the stability of the Nation's financial infrastructure.

We must put in place a regulatory structure that will not only protect consumers and investors but protect valuable financial sector jobs. In the news we heard about the collapse of AIG, Lehman, Fannie, Freddie, and Bear Stearns and the numerous banks that have either closed down or been purchased by other banks.

This really hits home in Ohio. National City, an institution that has been a pillar of the community for more than a century and a half, vanished over the course of a few months. We cannot forget about those Americans as we work to put a plan in place.

It boils down to this: People in my State want their hard-earned savings protected. They want to be able to get an affordable loan to purchase a home—on terms that they can understand. They want to know that when they invest, the institutions handling their investments aren't so over-extended that a light breeze causes their house of cards to tumble. And small businesses want access to credit without impossible-to-meet requirements.

The Administration plan seeks to:

- promote strong supervision and regulation of financial firms;
- establish comprehensive supervision and regulation of financial markets;
- protect consumers and investors from financial abuse;
- provide the government with tools it needs to manage financial crises; and
- raise international regulatory standards and improve international cooperation among financial institutions and markets.

As we consider the Administration's plan and what I am sure will be numerous competing proposals for regulatory reform, I have several questions:

- How will the Administration's plan actually protect the average consumer of credit products and the average investor?
- How can we have confidence that the Fed will be able to effectively execute its new responsibilities?
- How will the components of the new scheme be integrated?
- How will this plan prevent us from coming back to this same spot years from now?

We need vision and courage going forward. We also need to do more than pay lip service to the American consumer that we are "getting tough" on the institutions that caused this mess. We need to ensure that any new powers we give to existing institutions and any new agencies we create are designed to produce real results and not more of the same.

We need regulatory reform because, left to their own devices, too many financial institutions will act to preserve themselves at the risk of the system as a whole. Sensible bankers and insurers will have to pay the price for their selfish colleagues who think only in the short term. And so will the rest of us.

We cannot afford the *status quo.* We must act now to put a plan in place that protects consumers and investors, saves jobs, and ensures the integrity of our financial system.

PREPARED STATEMENT OF SENATOR MIKE CRAPO

I intend to push for reforms that modernize and rationalize our Federal financial regulatory system to handle the challenges of 21st century markets while ensuring American financial companies can compete in a global economy. Although the Administration's plan takes some important steps, it does not link the regulatory struc-

ture to the reasons why we regulate. Seven Federal regulators with overlapping missions and fragmented supervision oversee our markets and financial institutions. With the abolishment of the Office of Thrift Supervision and the creation of a Consumer Financial Protection Agency we will still have seven Federal regulators with overlapping missions. Increasing the complexity and fragmented approach to our regulatory structure is counter to reports that have identified several regulatory problems that hinder the ability of the U.S. to maintain its leadership role in financial services globally.

The goal should be to promote stable, orderly, and liquid financial markets so that our financial institutions can support the economy by making credit available to consumers and businesses. The recent taxpayer funded bailouts and investment scandals demonstrate our regulatory system is outdated and largely irrelevant. From banks and securities firms to insurance companies and money market funds, nearly all sectors of our financial system have experienced failures and received significant amounts of government assistance.

The implications of modernizing our financial regulatory structure are significant and we need to fully understand what the intended and unintended consequences of these changes are. For example, certain companies have not been allowed to fail and taxpayers have paid unprecedented amounts to cover the costs of bank failures and to bail out financial institutions. Does this white paper institutionalize government bailouts in a new resolution authority and does designating large and interconnected companies as Tier 1 Financial Holding Companies send a signal to the markets that these companies will not be allowed to fail?

Bifurcating safety-soundness oversight from consumer protection raises many questions. Good supervision should incorporate elements of both safety and soundness and consumer protection. For example, the absence of adequate underwriting, which played a role in some of the financial market problems that we have recently experienced, was as much a safety and soundness issue as a consumer protection issue. By putting the two areas into entirely different operations, each agency will lack the expertise to understand the issues that matter to the other, and the result could be less comprehensive oversight.

We should proceed carefully and deliberately in creating a new systemic risk regulator. Having the Federal Reserve become the systemic risk regulator for all large financial institutions concentrates enormous power in one agency.

How does this plan encourage investment and responsible lending to spur economic growth and help get our economy moving again?

PREPARED STATEMENT OF TIMOTHY GEITHNER

SECRETARY,
DEPARTMENT OF THE TREASURY

JUNE 18, 2009

FINANCIAL REGULATORY REFORM: A NEW FOUNDATION

Introduction

Over the past 2 years we have faced the most severe financial crisis since the Great Depression. Americans across the Nation are struggling with unemployment, failing businesses, falling home prices, and declining savings. These challenges have forced the government to take extraordinary measures to revive our financial system so that people can access loans to buy a car or home, pay for a child's education, or finance a business.

The roots of this crisis go back decades. Years without a serious economic recession bred complacency among financial intermediaries and investors. Financial challenges such as the near-failure of Long-Term Capital Management and the Asian Financial Crisis had minimal impact on economic growth in the U.S., which bred exaggerated expectations about the resilience of our financial markets and firms. Rising asset prices, particularly in housing, hid weak credit underwriting standards and masked the growing leverage throughout the system.

At some of our most sophisticated financial firms, risk management systems did not keep pace with the complexity of new financial products. The lack of transparency and standards in markets for securitized loans helped to weaken underwriting standards. Market discipline broke down as investors relied excessively on credit rating agencies. Compensation practices throughout the financial services industry rewarded short-term profits at the expense of long-term value.

Households saw significant increases in access to credit, but those gains were overshadowed by pervasive failures in consumer protection, leaving many Americans with obligations that they did not understand and could not afford.

While this crisis had many causes, it is clear now that the government could have done more to prevent many of these problems from growing out of control and threatening the stability of our financial system. Gaps and weaknesses in the supervision and regulation of financial firms presented challenges to our government's ability to monitor, prevent, or address risks as they built up in the system. No regulator saw its job as protecting the economy and financial system as a whole. Existing approaches to bank holding company regulation focused on protecting the subsidiary bank, not on comprehensive regulation of the whole firm. Investment banks were permitted to opt for a different regime under a different regulator, and in doing so, escaped adequate constraints on leverage. Other firms, such as AIG, owned insured depositories, but escaped the strictures of serious holding company regulation because the depositories that they owned were technically not "banks" under relevant law.

We must act now to restore confidence in the integrity of our financial system. The lasting economic damage to ordinary families and businesses is a constant reminder of the urgent need to act to reform our financial regulatory system and put our economy on track to a sustainable recovery. We must build a new foundation for financial regulation and supervision that is simpler and more effectively enforced, that protects consumers and investors, that rewards innovation, and that is able to adapt and evolve with changes in the financial market.

In the following pages, we propose reforms to meet five key objectives:

1. *Promote robust supervision and regulation of financial firms.* Financial institutions that are critical to market functioning should be subject to strong oversight. No financial firm that poses a significant risk to the financial system should be unregulated or weakly regulated. We need clear accountability in financial oversight and supervision. We propose:

- A new Financial Services Oversight Council of financial regulators to identify emerging systemic risks and improve interagency cooperation.
- New authority for the Federal Reserve to supervise all firms that could pose a threat to financial stability, even those that do not own banks.
- Stronger capital and other prudential standards for all financial firms, and even higher standards for large, interconnected firms.
- A new National Bank Supervisor to supervise all federally chartered banks.
- Elimination of the Federal thrift charter and other loopholes that allowed some depository institutions to avoid bank holding company regulation by the Federal Reserve.
- The registration of advisers of hedge funds and other private pools of capital with the SEC.

2. *Establish comprehensive supervision of financial markets.* Our major financial markets must be strong enough to withstand both systemwide stress and the failure of one or more large institutions. We propose:

- Enhanced regulation of securitization markets, including new requirements for market transparency, stronger regulation of credit rating agencies, and a requirement that issuers and originators retain a financial interest in securitized loans.
- Comprehensive regulation of all over-the-counter derivatives.
- New authority for the Federal Reserve to oversee payment, clearing, and settlement systems.

3. *Protect consumers and investors from financial abuse.* To rebuild trust in our markets, we need strong and consistent regulation and supervision of consumer financial services and investment markets. We should base this oversight not on speculation or abstract models, but on actual data about how people make financial decisions. We must promote transparency, simplicity, fairness, accountability, and access. We propose:

- A new Consumer Financial Protection Agency to protect consumers across the financial sector from unfair, deceptive, and abusive practices.
- Stronger regulations to improve the transparency, fairness, and appropriateness of consumer and investor products and services.
- A level playing field and higher standards for providers of consumer financial products and services, whether or not they are part of a bank.

4. *Provide the government with the tools it needs to manage financial crises.* We need to be sure that the government has the tools it needs to manage crises, if and when they arise, so that we are not left with untenable choices between bailouts and financial collapse. We propose:

- A new regime to resolve nonbank financial institutions whose failure could have serious systemic effects.
- Revisions to the Federal Reserve's emergency lending authority to improve accountability.

5. *Raise international regulatory standards and improve international cooperation.* The challenges we face are not just American challenges, they are global challenges. So, as we work to set high regulatory standards here in the United States, we must ask the world to do the same. We propose:

- International reforms to support our efforts at home, including strengthening the capital framework; improving oversight of global financial markets; coordinating supervision of internationally active firms; and enhancing crisis management tools.

In addition to substantive reforms of the authorities and practices of regulation and supervision, the proposals contained in this report entail a significant restructuring of our regulatory system. We propose the creation of a Financial Services Oversight Council, chaired by Treasury and including the heads of the principal Federal financial regulators as members. We also propose the creation of two new agencies. We propose the creation of the Consumer Financial Protection Agency, which will be an independent entity dedicated to consumer protection in credit, savings, and payments markets. We also propose the creation of the National Bank Supervisor, which will be a single agency with separate status in Treasury with responsibility for federally chartered depository institutions. To promote national coordination in the insurance sector, we propose the creation of an Office of National Insurance within Treasury.

Under our proposal, the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) would maintain their respective roles in the supervision and regulation of State-chartered banks, and the National Credit Union Administration (NCUA) would maintain its authorities with regard to credit unions. The Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) would maintain their current responsibilities and authorities as market regulators, though we propose to harmonize the statutory and regulatory frameworks for futures and securities.

The proposals contained in this report do not represent the complete set of potentially desirable reforms in financial regulation. More can and should be done in the future. We focus here on what is essential: to address the causes of the current crisis, to create a more stable financial system that is fair for consumers, and to help prevent and contain potential crises in the future. (For a detailed list of recommendations, please see Summary of Recommendations following the Introduction.)

These proposals are the product of broad-ranging individual consultations with members of the President's Working Group on Financial Markets, Members of Congress, academics, consumer and investor advocates, community-based organizations, the business community, and industry and market participants.

I. Promote Robust Supervision and Regulation of Financial Firms

In the years leading up to the current financial crisis, risks built up dangerously in our financial system. Rising asset prices, particularly in housing, concealed a sharp deterioration of underwriting standards for loans. The Nation's largest financial firms, already highly leveraged, became increasingly dependent on unstable sources of short-term funding. In many cases, weaknesses in firms' risk-management systems left them unaware of the aggregate risk exposures on and off their balance sheets. A credit boom accompanied a housing bubble. Taking access to short-term credit for granted, firms did not plan for the potential demands on their liquidity during a crisis. When asset prices started to fall and market liquidity froze, firms were forced to pull back from lending, limiting credit for households and businesses.

Our supervisory framework was not equipped to handle a crisis of this magnitude. To be sure, most of the largest, most interconnected, and most highly leveraged financial firms in the country were subject to some form of supervision and regulation by a Federal Government agency. But those forms of supervision and regulation proved inadequate and inconsistent.

First, capital and liquidity requirements were simply too low. Regulators did not require firms to hold sufficient capital to cover trading assets, high-risk loans, and off-balance sheet commitments, or to hold increased capital during good times to prepare for bad times. Regulators did not require firms to plan for a scenario in which the availability of liquidity was sharply curtailed.

Second, on a systemic basis, regulators did not take into account the harm that large, interconnected, and highly leveraged institutions could inflict on the financial system and on the economy if they failed.

Third, the responsibility for supervising the consolidated operations of large financial firms was split among various Federal agencies. Fragmentation of supervisory responsibility and loopholes in the legal definition of a "bank" allowed owners of banks and other insured depository institutions to shop for the regulator of their choice.

Fourth, investment banks operated with insufficient government oversight. Money market mutual funds were vulnerable to runs. Hedge funds and other private pools of capital operated completely outside of the supervisory framework.

To create a new foundation for the regulation of financial institutions, we will promote more robust and consistent regulatory standards for all financial institutions. Similar financial institutions should face the same supervisory and regulatory standards, with no gaps, loopholes, or opportunities for arbitrage.

We propose the creation of a Financial Services Oversight Council, chaired by Treasury, to help fill gaps in supervision, facilitate coordination of policy and resolution of disputes, and identify emerging risks in firms and market activities. This Council would include the heads of the principal Federal financial regulators and would maintain a permanent staff at Treasury.

We propose an evolution in the Federal Reserve's current supervisory authority for BHCs to create a single point of accountability for the consolidated supervision of all companies that own a bank. All large, interconnected firms whose failure could threaten the stability of the system should be subject to consolidated supervision by the Federal Reserve, regardless of whether they own an insured depository institution. These firms should not be able to escape oversight of their risky activities by manipulating their legal structure.

Under our proposals, the largest, most interconnected, and highly leveraged institutions would face stricter prudential regulation than other regulated firms, including higher capital requirements and more robust consolidated supervision. In effect, our proposals would compel these firms to internalize the costs they could impose on society in the event of failure.

II. Establish Comprehensive Regulation of Financial Markets

The current financial crisis occurred after a long and remarkable period of growth and innovation in our financial markets. New financial instruments allowed credit risks to be spread widely, enabling investors to diversify their portfolios in new ways and enabling banks to shed exposures that had once stayed on their balance sheets. Through securitization, mortgages and other loans could be aggregated with similar loans and sold in tranches to a large and diverse pool of new investors with different risk preferences. Through credit derivatives, banks could transfer much of their credit exposure to third parties without selling the underlying loans. This distribution of risk was widely perceived to reduce systemic risk, to promote efficiency, and to contribute to a better allocation of resources.

However, instead of appropriately distributing risks, this process often concentrated risk in opaque and complex ways. Innovations occurred too rapidly for many financial institutions' risk management systems; for the market infrastructure, which consists of payment, clearing, and settlement systems; and for the Nation's financial supervisors.

Securitization, by breaking down the traditional relationship between borrowers and lenders, created conflicts of interest that market discipline failed to correct. Loan originators failed to require sufficient documentation of income and ability to pay. Securitizers failed to set high standards for the loans they were willing to buy, encouraging underwriting standards to decline. Investors were overly reliant on credit rating agencies. Credit ratings often failed to accurately describe the risk of rated products. In each case, lack of transparency prevented market participants from understanding the full nature of the risks they were taking.

The build-up of risk in the over-the-counter (OTC) derivatives markets, which were thought to disperse risk to those most able to bear it, became a major source of contagion through the financial sector during the crisis.

We propose to bring the markets for all OTC derivatives and asset-backed securities into a coherent and coordinated regulatory framework that requires transparency and improves market discipline. Our proposal would impose record-keeping

and reporting requirements on all OTC derivatives. We also propose to strengthen the prudential regulation of all dealers in the OTC derivative markets and to reduce systemic risk in these markets by requiring all standardized OTC derivative transactions to be executed in regulated and transparent venues and cleared through regulated central counterparties.

We propose to enhance the Federal Reserve's authority over market infrastructure to reduce the potential for contagion among financial firms and markets.

Finally, we propose to harmonize the statutory and regulatory regimes for futures and securities. While differences exist between securities and futures markets, many differences in regulation between the markets may no longer be justified. In particular, the growth of derivatives markets and the introduction of new derivative instruments have highlighted the need for addressing gaps and inconsistencies in the regulation of these products by the CFTC and SEC.

III. Protect Consumers and Investors From Financial Abuse

Prior to the current financial crisis, a number of Federal and State regulations were in place to protect consumers against fraud and to promote understanding of financial products like credit cards and mortgages. But as abusive practices spread, particularly in the market for subprime and nontraditional mortgages, our regulatory framework proved inadequate in important ways. Multiple agencies have authority over consumer protection in financial products, but for historical reasons, the supervisory framework for enforcing those regulations had significant gaps and weaknesses. Banking regulators at the State and Federal level had a potentially conflicting mission to promote safe and sound banking practices, while other agencies had a clear mission but limited tools and jurisdiction. Most critically in the run-up to the financial crisis, mortgage companies and other firms outside of the purview of bank regulation exploited that lack of clear accountability by selling mortgages and other products that were overly complicated and unsuited to borrowers' financial situation. Banks and thrifts followed suit, with disastrous results for consumers and the financial system.

This year, Congress, the Administration, and financial regulators have taken significant measures to address some of the most obvious inadequacies in our consumer protection framework. But these steps have focused on just two, albeit very important, product markets—credit cards and mortgages. We need comprehensive reform.

For that reason, we propose the creation of a single regulatory agency, a Consumer Financial Protection Agency (CFPA), with the authority and accountability to make sure that consumer protection regulations are written fairly and enforced vigorously. The CFPA should reduce gaps in Federal supervision and enforcement; improve coordination with the States; set higher standards for financial intermediaries; and promote consistent regulation of similar products.

Consumer protection is a critical foundation for our financial system. It gives the public confidence that financial markets are fair and enables policy makers and regulators to maintain stability in regulation. Stable regulation, in turn, promotes growth, efficiency, and innovation over the long term. We propose legislative, regulatory, and administrative reforms to promote transparency, simplicity, fairness, accountability, and access in the market for consumer financial products and services.

We also propose new authorities and resources for the Federal Trade Commission to protect consumers in a wide range of areas.

Finally, we propose new authorities for the Securities and Exchange Commission to protect investors, improve disclosure, raise standards, and increase enforcement.

IV. Provide the Government With the Tools It Needs To Manage Financial Crises

Over the past 2 years, the financial system has been threatened by the failure or near failure of some of the largest and most interconnected financial firms. Our current system already has strong procedures and expertise for handling the failure of banks, but when a bank holding company or other nonbank financial firm is in severe distress, there are currently only two options: obtain outside capital or file for bankruptcy. During most economic climates, these are suitable options that will not impact greater financial stability.

However, in stressed conditions it may prove difficult for distressed institutions to raise sufficient private capital. Thus, if a large, interconnected bank holding company or other nonbank financial firm nears failure during a financial crisis, there are only two untenable options: obtain emergency funding from the U.S. Government as in the case of AIG, or file for bankruptcy as in the case of Lehman Brothers. Neither of these options is acceptable for managing the resolution of the firm

efficiently and effectively in a manner that limits the systemic risk with the least cost to the taxpayer.

We propose a new authority, modeled on the existing authority of the FDIC, that should allow the government to address the potential failure of a bank holding company or other nonbank financial firm when the stability of the financial system is at risk.

In order to improve accountability in the use of other crisis tools, we also propose that the Federal Reserve Board receive prior written approval from the Secretary of the Treasury for emergency lending under its "unusual and exigent circumstances" authority.

V. Raise International Regulatory Standards and Improve International Cooperation

As we have witnessed during this crisis, financial stress can spread easily and quickly across national boundaries. Yet, regulation is still set largely in a national context. Without consistent supervision and regulation, financial institutions will tend to move their activities to jurisdictions with looser standards, creating a race to the bottom and intensifying systemic risk for the entire global financial system.

The United States is playing a strong leadership role in efforts to coordinate international financial policy through the G20, the Financial Stability Board, and the Basel Committee on Banking Supervision. We will use our leadership position in the international community to promote initiatives compatible with the domestic regulatory reforms described in this report.

We will focus on reaching international consensus on four core issues: regulatory capital standards; oversight of global financial markets; supervision of internationally active financial firms; and crisis prevention and management.

At the April 2009 London Summit, the G20 leaders issued an eight-part declaration outlining a comprehensive plan for financial regulatory reform.

The domestic regulatory reform initiatives outlined in this report are consistent with the international commitments the United States has undertaken as part of the G20 process, and we propose stronger regulatory standards in a number of areas.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM TIMOTHY GEITHNER

Q.1. One key issue that will need to be resolved is how the Consumer Financial Protection Agency (CFPA) and the National Bank Supervisor (NBS) will be funded. Would you subject their funding to the appropriations process? Would you rely solely on fees charged to the regulated entities? Would you use the deposit insurance fund? Do you believe there should be parity between State and national charters with respect to the costs of their supervision? If so, how would you achieve that?

A.1. Under Treasury's proposed legislation, the CFPA is authorized to appropriate "such sums as are necessary" for it to fully discharge its duties under the statute, and recover these appropriations through fees on covered entities. Such fees could be assessed only after promulgating rules with respect to such fees, which is consistent with methods employed by other independent regulators. That rulemaking process would include publishing any proposed fees for public notice and comment.

The Office of Management and Budget (OMB) will exercise apportionment authority over the CFPA. This authority will provide OMB the opportunity for review and discussion with the Agency to ensure that CFPA spending is planned and executed according to law.

The CFPA's budget will include the resources used by the existing regulators to carry out their financial consumer protection functions, which will all be transferred to the new agency. The agencies that will transfer functions to the CFPA include the Federal Reserve Board and Federal Reserve Banks, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Federal Trade Commission (FTC), and the Department of Housing and Urban Development. In addition to these resources, the CFPA will need funding to provide a level playing field by extending the reach of Federal oversight to the nonbank providers of consumer financial products and services.

Under Section 1024 of the legislation, the CFPA would have a mandate to allocate more of its resources to institutions that pose more risks to consumers. Community banks are close to their customers and have often provided simpler, easier-to-understand products with greater care and transparency than other segments of the market. Such banks will receive proportionally less oversight from the CFPA. Moreover, the Administration proposes that community banks will pay no more for Federal consumer protection supervision after the establishment of the CFPA than they do today.

Like the OCC, the newly constituted NBS, which will be created through the consolidation of the activities of the OCC and OTS, will continue to collect fees to cover the cost of safety and soundness supervision of institutions with a national charter.

Q.2. The Administration's proposal would fund the resolution of a large nonbank financial company initially through the Treasury, with any losses to the government recouped through an assessment on holding companies. Other proposals have called for an *ex ante*

funding approach: financial organizations would pay assessments into a fund that would be available to cover all or part of the costs of resolving a systemically important financial institution. Proponents of an *ex ante* approach argue that the fund would reinforce the commitment of the government to unwind troubled large financial organizations rather than propping them up with taxpayer funds. The assessments, like the Administration's proposed higher capital requirements, would also provide a disincentive for a company to grow in size or complexity to a level that could create systemic risk. Can you elaborate on why the Administration instead proposes *ex post* funding with initial reliance on Treasury funds?

A.2. Our proposal for a special resolution regime is intended for use only in extraordinary circumstances and subject to very high procedural hurdles. It is modeled on the existing systemic risk exception under FDIC Improvement Act of 1991 (FDICIA). By way of example, that exception was not used at all from the time FDICIA became law until the current crisis. Under our proposal, the special resolution regime would not replace bankruptcy procedures in the normal course of business. Bankruptcy is and will remain the dominant tool for handling the failure of a bank holding company. The special resolution regime would only be triggered by a threat to financial stability.

Because this regime will be used only in exceptional circumstances when the system is at risk, we believe that the creation of an *ex ante* fund is not necessary. Moreover, the *ex ante* regime could actually make intervention more likely because firms that had paid into the fund would expect to be able to access the monies held by the fund and because the government may be more likely to expend money to stabilize a firm if a readily available fund was accessible for that purpose. In our proposal, the high procedural hurdles will help ensure that these powers are only used when appropriate.

An *ex post* funding mechanism provides large financial firms with stronger incentives to monitor the risk taking of systemic firms. The funding mechanism entails no assessments on the large firms if no systemic firms fail but potentially large assessments on the firms if one or more systemic firms fail. As such, *ex post* funding promotes *ex ante* market discipline of the systemic firms.

Ex post funding provides large financial firms with strong incentives to support a private sector recapitalization of a systemic firm in severe distress—rather than a government resolution with substantial assistance. If large financial firms understand that they must pay after-the-fact for the clean-up of a systemic firm if it fails, the large firms, which will collectively make up a substantial portion of the counterparties of the failing systemic firm, will have strong incentives to arrange a private sector solution to the problems of the failing firm (including, for example, by consenting to debt-for-equity swaps).

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM TIMOTHY GEITHNER

Q.1. *Role of the Fed*—Secretary Geithner, the Administration proposes to expand the Fed's powers by giving it authority to regulate

systemically significant nonbank financial institutions. This would mean that the Chairman of the Fed would not only have to be an expert in monetary policy and banking regulation, but also would have to be an expert in systemic risk regulation.

Is it reasonable to expect that any one person can possibly acquire the expertise in so many highly technical fields?

Do you think that one person could possibly oversee a complex institution like Citigroup and still have time to be fully prepared to make decisions on monetary policy?

A.1. As the supervisor of bank holding companies and financial holding companies, the Federal Reserve already supervises all large U.S. commercial and investment banking firms. As stated elsewhere in my responses to these questions for the record, we propose modestly expanding the Federal Reserve's regulatory authority over the largest and most interconnected financial institutions in large part because we believe that the Federal Reserve is the only agency with the depth of expertise in financial institutions and markets that such regulation would require. The role of banking supervision is closely tied to the Federal Reserve's role in promoting financial stability. To do this, it needs deep and direct knowledge of the financial system through direct supervision of financial firms.

Moreover, our proposals would also remove responsibility for consumer protection supervision and regulation from the Federal Reserve because we believe that this mission is better conducted by one agency with market wide coverage and a central mission of consumer protection. This mission is not closely related to the core responsibilities of the Nation's central bank. This step should make it easier for the Chairman and the Board to focus on core responsibilities.

Q.2. *Consumer Protection and Safety and Soundness*—In making the case for a separate consumer protection agency the administration's white paper states "banking regulators at the State and Federal level had a potentially conflicting mission to promote safe and sound banking practices, while other agencies had a clear mission, but limited tools and jurisdiction."

Secretary Geithner, please articulate the "potentially conflicting mission" between safety and soundness and consumer protection. It seems clear that a prudently underwritten loan will ensure that a consumer is protected, while also ensuring that a bank operates in a safe and sound manner.

A.2. While in rare cases there may be conflicts between prudential regulation and consumer protection, we agree that strong consumer protection supports safety and soundness. We reject the notion that profits based on unfair and deceptive practices can ever be considered sound. Requiring all financial institutions to act fairly and transparently will improve the safety and soundness of banks while also providing consumers with the protection they need to make sound financial decisions.

For the Consumer Financial Protection Agency (CFPA), protecting consumers will be its sole mission, whereas it is a secondary mission at the existing prudential regulators. Under the current system, consumer protection has always taken a back seat

to safety and soundness concerns within the prudential regulators. In the lead-up to the current crisis, safety and soundness regulators failed to protect consumers from exploding subprime and exotic mortgages and unfair credit card features, and were far too slow in issuing rules to address these problems. The CFPA would have the responsibility and authority to act more quickly to protect consumers when they face undue risk of harm from changing products or practices.

Our proposals are designed so that the CFPA prescribes regulations that are consistent with maintaining the safety and soundness of banks. The CFPA would be required by statute to consult with each of the prudential supervisors before issuing a new regulation. In addition, we propose that the National Bank Supervisor would be one of the five members of the CFPA board. These measures provide further assurance that the CFPA will consider safety and soundness interests when adopting regulations. Finally, in the very rare instance that conflicts do arise, we propose that the legislation incorporate reasonable dispute resolution mechanisms to force the CFPA and the prudential regulator to resolve any conflicts that they cannot work out on their own.

Q.3. *Role for Congress*—Secretary Geithner, the Administration's Proposal grants the Fed and several other agencies vast new powers. It also gives the Treasury authority over the use of the Fed's 13(3) loan window. It also gives the Treasury, the FDIC, and the Fed authority to decide whether the Federal Government will bailout a troubled financial institution. Nowhere in the Proposal, however, does it consider granting Congress more authority over our regulatory system. There is not even a reporting requirement to Congress.

Do you think that Congress should have a decision-making role in our financial regulatory system?

Do you think that it is consistent with our republican form of government to concentrate so much power in independent agencies, such as the Fed?

Would you support requiring Congressional approval before the Federal Government could bail out financial institutions?

A.3. I believe that Congress has a strong role to play in reforming the financial regulatory system. Critically, it is Congress that will consider and enact the legislation that will form the framework for our new financial regulatory system. Of equal importance will be Congress' ongoing oversight role, which will be enhanced by many of our proposals. For example, the Financial Services Oversight Council will have the critical responsibility of identifying emerging threats and coordinating a response—because we know that threats to our economy can emerge from any corner of the financial system.

The Council is required to report to Congress each year on these risks and threats and to coordinate action by individual regulators to address them. The Consumer Financial Protection Agency (CFPA) will have reporting requirements related to its rulemaking, supervisory and enforcement activity, and regarding consumer complaints. In addition, the Director of the Office of National In-

surance will be required to submit an annual report to Congress on the insurance market.

In formulating our proposals we were careful to include appropriate checks and balances to avoid concentrating authority in any single agency. For example, although our proposals provide for a modest enhancement of the Federal Reserve's powers, our proposals also move consumer protection authority from the Federal Reserve to a dedicated agency with a single mission and marketwide coverage. Moreover, our proposed resolution regime, which is modeled on the existing resolution regime for insured depository institutions, requires the consent of three separate agencies; Treasury must consult with the President, and it must receive the written recommendation of two-thirds of the members of the boards of both the Federal Reserve Board and the FDIC (or the SEC, if the SEC is the institution's primary supervisor).

Moreover, even after the decision to use the resolution authority is made, the choice of the appropriate resolution method is not left to one agency. Under our proposals, the agency responsible for managing the resolution and Treasury must agree on the appropriate method. We expect this process will allow for timely decision making during a crisis while ensuring that there are appropriate perspectives included and that this new authority is exercised only under extraordinary circumstances.

Anytime that this authority is exercised, the Treasury Secretary must submit a report to Congress regarding the determination, and each determination is also reviewed by the Government Accountability Office.

Q.4. *Hedge Funds*—Secretary Geithner, you favor the mandatory registration of advisors to hedge funds, venture capital funds, and private equity funds with the SEC. As the Madoff and Stanford cases painfully illustrate, being registered with the SEC does not guarantee that a firm will be closely monitored. The administration white paper cites hedge fund de-leveraging as a contributor to the crisis.

How will the registration of hedge fund advisors prevent them from de-leveraging in future crises?

A.4. As noted in the Treasury's report to Congress, at various points in the financial crisis, de-leveraging by hedge funds contributed to the strain on financial markets. Because these funds were not required to register with regulators, the government lacked reliable, comprehensive data with which to assess this market activity and its potential systemic implications. Requiring registration of hedge fund advisors would allow data to be collected that would permit an informed assessment by the government of the market positions of such funds, how such funds are changing over time and whether any such funds or fund families have become so large, leveraged, or interconnected that they require additional oversight for financial stability purposes.

Among other requirements, all registered hedge fund advisors would be subject to recordkeeping and reporting requirements, including the following information for each private fund advised by the adviser: amount of assets under management, borrowings, off-balance sheet exposures, trading and investment positions, and

other information necessary or appropriate for the protection of investors or for the assessment of systemic risk. Information would be shared with the Federal Reserve, which would determine whether such a firm meets the Tier 1 Financial Holding Company (Tier 1 FHC) criteria. Designation as a Tier 1 FHC would subject the firm to robust and consolidated supervision and regulation as Tier 1 FHCs. The prudential standards for Tier 1 FHCs would include capital, liquidity, and risk management standards that are stricter and more conservative than those applicable to other firms to account for the risks that their potential failure would impose on the financial system.

Q.5. What other problems did hedge funds, private equity funds, and venture capital funds cause and how will SEC registration of advisors to those funds address the problems caused by each of these types of funds?

A.5. Although these funds do not appear to have been at the center of the current crisis, de-leveraging contributed to the strain on financial markets and the lack of transparency contributed to market uncertainty and instability. New advisor registration, recordkeeping, and disclosure requirements will give regulators access to important information concerning funds in order to address opacity concerns. Information about the characteristics of a hedge fund, including asset size, borrowings, off-balance sheet exposure, and other matters will help regulators to protect the financial system from systemic risk and help regulators to protect investors from fraud and abuse. In addition, this information will allow regulators to make an assessment of whether a firm is so large, leveraged, or interconnected that it poses a threat to financial stability, and thus require regulation as Tier 1 FHC.

Q.6. How should the SEC allocate its examination resources between advisors to private pools of capital, on the one hand, and advisors to mutual funds and other advisors that serve the less affluent in our society, on the other?

A.6. We defer to the SEC to address how resources should be allocated. In testimony on July 14, SEC Chairman Mary Schapiro addressed strengthening SEC examination and oversight and improving investor protection. The Chairman noted that the SEC is working towards improving its risk-based oversight, including extending that oversight to investment advisers. The SEC is recruiting additional professionals with specialized expertise, creating new positions in its examination program, and making use of automated systems to assist in determining which firms or practices raise red flags and require greater scrutiny.

Q.7. *Credit Rating Agencies*—Secretary Geithner, the Administration's proposal calls for reduced regulatory reliance on credit ratings, but seems focused only on reducing reliance on ratings of structured products.

Will you be recommending a legislative mandate to the SEC and other regulatory agencies to find ways to reduce their reliance on ratings of all types, not just ratings on structured products?

A.7. It is clear that over-reliance on ratings from credit rating agencies contributed to the fragility of the system in the current

crisis—especially as the systematic underestimation of risk in structured securities became clear. While the regulatory reliance on ratings covers both structured and unstructured products, we believe that the problems in the markets for structured products were particularly acute.

Our legislative proposal includes a requirement that rating agencies distinguish the symbols used to rate structured products from those used for unstructured products. This will not directly reduce the use of ratings, but it will require that regulators and investors reassess their approaches to ratings—in regulations, contracts, and investment guidelines.

In addition, we are working with the SEC and through the President's Working Group to identify other areas in Federal regulations where there is a need to reassess the use of ratings, with respect to both structured and unstructured products. For instance, as part of a comprehensive set of money market fund reform proposals, the SEC requested public comment on whether to eliminate references to ratings in the regulation governing money market mutual funds.

Q.8. *Fed Study of Itself*—In the Administration's proposal, after giving the Fed extensive new regulatory power, you would ask the Fed to review "ways in which the structure and governance of the Federal Reserve System affect its ability to accomplish its existing and proposed functions."

Why should we give the Fed these additional responsibilities prior to knowing if they are able to administer them?

Why do you have the Fed study itself?

Were other entities considered as alternatives for the purposes of conducting the study?

A.8. As the supervisor of bank holding companies and financial holding companies, the Federal Reserve already supervises all large U.S. commercial and investment banking firms. As stated elsewhere in the responses to these questions for the record, we propose modestly expanding the Federal Reserve's regulatory authority over the largest and most interconnected financial institutions in large part because we believe that the Federal Reserve is the only agency with the depth of expertise in financial institutions and markets that such regulation would require. The role of banking supervision is closely tied to the Federal Reserve's role in promoting financial stability. To do this, it needs deep and direct knowledge of the financial system through direct supervision of financial firms.

The proposed role for the Fed in supervising nondepository financial firms will require the Federal Reserve to acquire additional expertise in some areas of financial activity. But the potential extension of its consolidated supervision authority to some nonbanking financial institutions represents an evolution rather than a revolution in the Federal Reserve's role in the financial markets.

At the same time, the structure and governance of the Federal Reserve System should be reviewed to determine whether and, if so, how it can be improved to facilitate accomplishment of the agency's current and proposed responsibilities. Every agency has the responsibility to review itself periodically to ensure that it is organized in a manner that best promotes its mission.

Q.9. *Congress Needs To Do Its Homework*—Secretary Geithner, the Administration's Proposal defers making decisions on how to address the GSEs, improve banking supervision, modernize capital requirements, update insurance regulation, improve accounting standards, coordinate SEC and CFTC regulation, and even how to define systemic risk. The Administration has said that it will study these topics before proceeding.

Should not Congress wait to pass reform legislation until after it has had the benefit of the Administration's studies on these topics?

Would not that help ensure that Congress acts in an informed manner and that the final legislation is based on the best available information?

A.9. The reform proposals for which we have submitted draft legislation in June and July do not depend on completion of the studies. It is important that Congress move forward to enact legislation to reform our financial regulatory system, while regulators, at the same time, move forward to find ways to improve the nuts and bolts of supervising U.S. financial firms.

Q.10. *Fed v. Systemic Risk Regulator*—Secretary Geithner, despite strong opposition in Congress to expanding the powers of the Fed, the Administration has proposed doing just that. Do you recognize that this will create significant hurdles for passing regulatory reform?

Is it more important to you that some entity be charged with regulating systemic risk, or must the Fed be the systemic risk regulator?

A.10. We chose not to make one agency the "systemic risk regulator" or "super regulator" because our system should not depend on the foresight of a single institution or a single person to identify and mitigate systemic risks. This is why we have proposed that the critical role of monitoring for emerging risks and coordinating policy be vested in a Financial Services Oversight Council rather than the Federal Reserve or any other single agency. Each Federal supervisor will contribute to the systemic analysis of the Council through the institution-focused work of their examiners.

We did propose an evolution in the Federal Reserve's authority to include the supervision and regulation of the largest and most interconnected financial firms. The Federal Reserve is the appropriate agency because of its depth of expertise, its existing mandate to promote financial stability, and its existing role as the supervisor for all large commercial and investment banking firms, including bank and financial holding companies.

Q.11. *Basel Capital Accords*—Secretary Geithner, in the Obama Administration's white paper, you state that the administration will recommend various actions to the Basel Committee on Banking Supervision (BCBS).

Previously, the BCBS has approved capital plans that were deemed inadequate by many in Congress, as well as the bank regulators.

What will you do if the BCBS returns with measures and definitions that raise concerns along the same lines as Basel II?

For the record, will you seek alterations to their standards as was done with Basel II, if the new standards are considered inadequate?

A.11. The U.S. banking regulators have always played a significant role in the Basel Committee's policy development process and we strongly believe that they will be highly influential in the next phase of capital proposals in ways that will address flaws in the Basel II framework that have been made manifest by the current economic crisis.

The U.S. regulatory community considers the Basel Committee to be a useful and receptive forum in which international supervisors can set consistent international supervisory standards. U.S. supervisors have and will continue to push for improvements to those standards. For example, the Basel Committee just released in mid-July significant enhancements to the Basel II framework that increase risk weights for the trading book, certain securitizations, and off-balance sheet activities, as supported by the President and myself at the G20 Leaders Summit in April.

Q.12. *Basel Leverage Measurement*—Mr. Secretary, in the white paper, you clearly state that the Obama Administration will, "urge the BCBS to develop a simple, transparent, nonmodel based measure of leverage, as recommended by the G20 leaders."

Please expand on this statement and what manner of measuring leverage you envision, including what criteria will be used and how you arrived at these answers?

A.12. As we explained in the Treasury Department's September 3, 2009, "Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms," risk-based capital rules are a critical component of a regulatory capital regime; however, it is impossible to construct risk-based capital rules that perfectly capture all the risk exposures of banking firms. Inevitably, there will be gaps and weak spots in any risk-based capital framework and regulatory arbitrage activity by firms will tilt asset portfolios and risk taking toward those gaps and weak spots. A simple leverage constraint would make the regulatory system more robust by limiting the degree to which such gaps and weak spots in the risk-based capital framework can be exploited. A simple leverage constraint also can help reduce the threats to financial stability from categorical misjudgments about risk by market participants and the official sector.

In addition, imposing a leverage constraint on banking firms would have macroprudential benefits. The balance sheets of financial firms and the intermediation chains between and among financial firms tend to grow fastest during good economic times but become subject to rapid reversal when economic conditions worsen. Supervisors generally have failed to exercise discretion to constrain leverage leading into a boom. A simple leverage ratio acts as a hard-wired dampener in the financial system that can be helpful to mitigate systemic risk.

It is important to recognize that the leverage ratio is a blunt instrument that, viewed in isolation, can create its own set of regulatory arbitrage opportunities and perverse incentive structures for banking firms. The existing U.S. leverage ratio is calculated as the

ratio of Tier 1 capital to total balance sheet assets. To mitigate potential adverse effects from an overly simplistic leverage constraint, the constraint going forward should at a minimum incorporate off-balance sheet items. It is also important to view the leverage constraint as a complement to a well designed risk-based capital requirement. Although it may be possible for banking firms to either arbitrage any free-standing risk-based capital requirement or any free-standing simple leverage constraint, it is much more difficult to arbitrage both frameworks at the same time.

Q.13. *Supervisory Colleges*—Mr. Secretary, in the white paper, you state that, "supervisors have established 'supervisory colleges' for the 30 most significant global financial institutions. The supervisory colleges for all 30 firms have met at least once."

Will information from these meetings be made public; will there be publication of any agendas, minutes, plans, membership, *etc.*?

If this information will not be made public, will there be the opportunity for Congressional staff to receive reports and briefings of the conduct and actions of these colleges?

Will the firms that are being examined have any opportunity to receive any information about these meetings?

A.13. Supervisory colleges are confidential meetings, held by regulators from multiple countries, which function as an information-sharing mechanism with regards to large cross-border financial institutions. The information shared in these meetings is governed by information sharing agreements signed by the participating regulatory organizations.

Supervisory colleges are not themselves decision-making regulatory bodies. The information shared within a supervised institution's college is used to assist regulators in conducting their supervisory responsibilities over that institution. A particular firm may be invited to brief regulators on specific topics. However, any resulting regulatory actions are conducted by the respective regulatory agencies. The Federal Reserve Board of Governors, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission participate in the supervisory colleges and can be contacted for further information.

Q.14. *Implications of Resolution Regime*—Mr. Secretary, in the white paper, you state that the proposed resolution regime would provide authority to avoid disorderly resolution of any systemically critical firm. You also write that national authorities are inclined to protect assets with their own jurisdictions. I would hope that our regulators would continue to have this mind-set, to spare the U.S. taxpayer from additional costs. It seems that this paper takes a negative view of this mind-set.

Can you explain your statement further?

Also, please explain to the Committee why protecting assets, which protects the taxpayer, should not be the focus of our national regulators?

A.14. Our proposal presents a new resolution regime, beyond what the U.S. already has, only where the failure of certain bank holding companies or nonbank financial firms threatens the stability of the entire financial system. The authority to invoke resolution procedures for these large entities would be used only for extraordinary

circumstances and would be subject to strict governance and control procedures. Furthermore, the purpose of the expanded resolution regime would be to unwind, dismantle, restructure, or liquidate the firm in an orderly way to minimize costs to taxpayers and the financial system; all costs to exercise this authority would be recouped through assessments and liquidation of any acquired assets, therefore sparing the taxpayer.

The global nature of the current crisis has also shown that in the failure of globally active financial firms, there needs to be improved coordination between national authorities representing jurisdictions that are affected. No common procedure exists among countries with respect to the failure of a large financial firm. The aim of this cross-border coordination should be to establish fair and orderly procedures to resolve a firm according to a system of laws and rules that investors can rely on as well as to protect the interests of U.S. taxpayers in globally active financial firms. The absence of predictability in cross-border procedures was a contributing factor to the contagion in our financial markets in the fall of 2008.

Q.15. *Federal Reserve Supervision of Foreign Tier 1 Financial Holding Companies*—Secretary Geithner, you “propose to change the Financial Holding Company eligibility requirements . . . but do not propose to dictate the manner in which those requirements are applied to foreign financial firms with U.S. operations.”

Please clarify this statement. Do you foresee the Federal Reserve getting information from other national supervisors or do you see the Federal Reserve conducting examinations of foreign Financial-Holding Companies overseas?

What criteria would you recommend the Federal Reserve use when they evaluate foreign parent banks? Many financial products differ in other parts of the world, how should the Federal Reserve evaluate those products’ safety and soundness for the parent company balance sheet?

A.15. Treasury intends to work with the Financial Services Oversight Council and the Federal Reserve Board to create a regulatory framework for foreign companies operating in the United States that are deemed to be Tier 1 Financial Holding Companies (FHCs). That framework will be comparable to the standards applied to domestic Tier 1 FHCs, giving due regard to the principle of national treatment and equality of competitive opportunity.

In determining today whether a foreign bank is well capitalized and well managed in accordance with FHC standards, the Board, relying on the existing Bank Holding Company Act, may take into account the foreign bank’s risk-based capital ratios, composition of capital, leverage ratio, accounting standards, long-term debt ratings, reliance on government support to meet capital requirements, the anti-money laundering procedures, whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis, and other factors that may affect analysis of capital and management.

While not conducting examinations of foreign banks in a foreign country, the Federal Reserve Board consults with the home country supervisor for foreign banks as appropriate. Treasury intends to

work with the Federal Reserve Board to determine what modifications to the existing FHC framework are needed for new foreign Tier 1 financial holding companies.

Q.16. *New Financial Stability Board (FSB)*—Mr. Secretary, in the white paper, you "recommend that the FSB complete its restructuring and institutionalize its new mandate to promote global financial stability by September 2009."

To whom will the FSB be accountable and from where will it receive its funding?

Will the FSB make their reports and conclusions public?

Will the Congress be able to have access to FSB documents and decisions?

A.16. The G20 Leaders in April 2009 agreed that the Financial Stability Forum should be reestablished as the Financial Stability Board (FSB) and be given a stronger mandate. Its membership was expanded to include all G20 member countries. The FSB is composed of finance ministries, central banks, regulatory authorities, international standard-setting bodies, and international institutions. It is supported by a small secretariat provided by the Bank for International Settlements.

The FSB provides public statements following its meetings and may issue papers on important issues from time to time. It regularly posts information to its Web site (*www.financialstabilityboard.org*), which is available to Congress and the general public. The FSB can provide coordination and issue recommendations and principles (*e.g.,* on crisis management; principles on compensation; protocols for supervisory colleges). The FSB operates as a consensus organization and it is up to each country whether and how to implement the recommendations of the FSB. The point of accountability for decisions and responses lies with each national regulator. The U.S. will work through the FSB as an effective body to coordinate and align international standards with those that we will set at home.

Q.17. *Adequacy of the Proposal*—Secretary Geithner, the Administration's Proposal aims to address the causes of the financial crisis by closing regulatory gaps. I would like to know more about which gaps in our financial supervisory system the Administration believes contributed to the crisis.

What are two cases where supervisory authority existed to address a problem but where regulators nevertheless failed act?

What are two cases where supervisory authority did not exist to address a problem and regulators were unable to act?

Does the Administration's Proposal address all of the cases you cited in your answers?

A.17. There were a number of cases in which supervisory authority existed but supervisors did not act in a timely and forceful fashion.

It was clear, at least by the early to mid-2000s, that banks and nonbanks were making subprime and nontraditional mortgage loans without properly assessing that the borrowers could afford the loans once scheduled payment increases occurred. Yet supervisors did not issue guidance requiring banks to qualify borrowers at the fully indexed interest rate and fully amortizing payment until 2006 and 2007. By consolidating consumer protection author-

ity into a single agency with a focused mission, the CFPA will be able to recognize when borrowers are receiving loans provided in an unfair or deceptive manner earlier, and it will act more quickly and effectively through guidance or regulation to address such problems.

In the securitization markets, regulatory authority existed to address the problems that emerged in the current crisis but the regulatory actions were not taken. For instance, regulators had the ability to address the treatment of off-balance sheet risks that many institutions retained when they originated new financial products such as structured investment vehicles and collateralized debt obligations, but supervisors did not fully grasp these risks and did not require sufficient capital to be held. Our proposals would increase capital charges for off-balance sheet risks to account more fully for those risks.

In addition, in many instances, regulators simply lacked the authority to take the actions necessary to address problems that existed.

For example, independent mortgage companies and brokers were major players in the market for nontraditional and sub-prime mortgages at the heart of the foreclosure crisis and operated without Federal supervision. Under our proposals, they would have been subject to supervision and regulation by the proposed CFPA.

Similarly, AIG took advantage of loopholes in the SHC act and was not adequately supervised on a consolidated basis. Under our proposals, AIG would have been subject to supervision and regulation by the Federal Reserve for safety and soundness, with an explicit mandate to look across the risks to the enterprise as a whole, not simply to protect the depository institution subsidiary.

As discussed above, the Administration's proposals create a comprehensive framework that would have addressed each of these failures.

Q.18. *Fed as Consolidated Supervisor*—Secretary Geithner, I find it interesting that, under your proposal, the entire financial industry would be within the Federal Reserve's regulatory reach. While you have created a shadow consolidated regulator, you have not bothered to get rid of the other regulators.

If you are intent on creating a single financial regulator, why not move everything into an agency with political accountability and eliminate the other regulatory agencies?

A.18. The entire financial industry would not be within the Federal Reserve's regulatory reach and we are not intending to create a single financial regulator. The Financial Services Oversight Council will have the authority and responsibility to identify emerging risks to the financial system and will help facilitate a coordinated response. In critical markets, like those for securities and derivatives, the SEC and CFTC will play leading roles. We are also proposing to retain and enhance crucial roles for the National Bank Supervisor and the FDIC on prudential regulation, and resolution of banks. The Federal Reserve would be the consolidated regulator of Tier 1 FHCs and would be responsible, as it is today, for prudential matters in the basic plumbing of the system—payment, settlement, and clearance systems.

In formulating our proposals we were careful to include appropriate checks and balances to avoid concentrating authority in any single agency. For example, although our proposals provide for a modest enhancement of the Federal Reserve's powers, our proposals also strip power from the Federal Reserve in the consumer protection area.

Q.19. *Regulatory Overlap*—Secretary Geithner, the Administration's proposal states that jurisdictional boundaries among agencies should be drawn clearly to avoid mission overlap and afford agencies exclusive regulatory authority.

How do you reconcile that principle with the proposal to expand the Fed's regulatory authority into so many different areas, many of which already have primary regulators?

A.19. In Treasury's report to Congress, we articulate a principle that agencies should be held accountable for critical missions such as promoting financial stability and protecting consumers of financial products. The consolidated supervisor of the holding company and the functional supervisor of the subsidiary each have critical roles to play.

Q.20. *Over-the-Counter Derivatives*—Secretary Geithner, the Administration does not appear to have made much headway in fleshing out the details of last month's outline for regulating over-the-counter derivatives.

How will you encourage standardization of derivatives without preventing companies from being able to buy derivatives to meet their unique hedging needs?

A.20. As you know, we have now sent up detailed legislative language to implement our proposal. Any regulatory reform of magnitude requires deciding how to strike the right balance between financial innovation and efficiency on the one hand, and stability and protection on the other. We failed to get this balance right in the past. If we do not achieve sufficient reform, we will leave ourselves weaker as a Nation and more vulnerable to future crises.

Our proposals have been carefully designed to provide a comprehensive approach. That means strong regulation and transparency for all OTC derivatives, regardless of the reference asset, and regardless of whether the derivative is customized or standardized. In addition, our plan will provide for strong supervision and regulation of all OTC derivative dealers and all other major participants in the OTC derivative markets.

We recognize, however, that standardized products will not meet all of the legitimate business needs of all companies. That is why our proposals do not—as some have suggested—ban customized OTC derivatives. Instead, we propose to encourage substantially greater use of standardized OTC derivatives primarily through higher capital charges and margin requirements on customized derivatives, and thereby facilitate a more substantial migration of these OTC derivatives on to central clearinghouses and exchanges.

Q.21. *Systemically Significant Firms*—Secretary Geithner, systemically significant firms, or Tier 1 Financial Holding Companies, will be required to make enhanced public disclosures "to support market evaluation."

Don't you believe that giving these firms a special label, a special oversight regime, and special disclosure will simply send a signal to the market that these firms are too big to fail and therefore do not need to be monitored?

A.21. Identification as a Tier 1 Financial Holding Company (Tier 1 FHC) does not come with any commitment of government support nor does it provide certain protection against failure. Instead our proposals would apply stricter prudential standards and more stringent supervision. For example, higher capital charges for Tier 1 FHCs would be used to account for the greater risk to financial stability that these firms could pose if they failed. It is designed to internalize the externalities that their failure might pose, to reduce incentives to excessive risk-taking at the taxpayer's expense, and to create a large buffer in the event of failure. In addition, in the event of failure, our proposals provide for a special resolution regime that would avoid the disruption that disorderly failure can cause to the financial system and the economy. That regime, however, would be triggered only in extraordinary circumstances when financial stability is at risk, and bankruptcy would remain the dominant tool for handling the failure of a financial company. Moreover, the purpose of the special resolution regime is to provide the government with the option of an orderly resolution, in which creditors and counterparties may share in the losses, without threatening the stability of the financial system.

Q.22. *Federal Reserve and Systemically Important Firms*—Secretary Geithner, under your proposal, the Federal Reserve would identify and regulate firms the failure of which, could pose a threat to financial stability due to their combination of size, leverage, and interconnectedness. It is unclear just what types of companies might fall into this new category of so-called Tier 1 Financial Holding Companies, because it will be up to the Fed to identify them.

Could Starbucks—which offers a credit card and would certainly affect numerous sectors of the economy if it failed—be classified as a Tier 1 Financial Holding Company and be subjected to Fed oversight?

A.22. Starbucks is not a financial firm and therefore would not qualify as a Tier 1 FHC. Starbucks currently offers a credit card through an independent financial institution.

Q.23. *Financial Services Oversight Council*—Secretary Geithner, the Administration recommends replacing the President's Working Group on financial Markets with a Financial Services Oversight Council.

Aside from having slightly enlarged membership and a dedicated staff, how will this Council differ from the PWG?

Is this anything more than a cosmetic change?

A.23. There are important differences between the President's Working Group (PWG) and the Financial Services Oversight Council (FSOC or Council). As an initial matter, the PWG was created by executive order and the Council would have permanent statutory status. In addition, the Council would have a substantially expanded mandate to facilitate information sharing and coordination, identify emerging risks, advise the Federal Reserve on the identification of Tier 1 FHCs and systemically important payment, clear-

ing, and settlement activities, and provide a forum in which supervisors can discuss issues of mutual interest and settle jurisdictional disputes. It would also enjoy the benefit of a dedicated staff that will enable it to undertake its missions in a unified way and to effectively conduct analysis on emerging risks.

In addition, unlike the PWG, the Council will have authority to gather information from market participants and will report to Congress annually on financial market developments and emerging systemic risks.

Q.24. *Identifying Systemic Risk*—Secretary Geithner, your proposal gives the Federal Reserve the authority to identify and regulate financial firms that pose a systemic risk due to their combination of size, leverage, and interconnectedness. Because neither "systemic risk" nor "financial firm" is defined, it is unclear what types of firms will fall within the Tier 1 Financial Holding Company designation. Theoretically, the term could include large investment advisers, mutual funds, broker-dealers, insurance companies, private equity funds, pension funds, and sovereign wealth funds, to name a few possibilities.

What further specificity will you be providing about your intentions with respect to the reach of the Fed's new powers?

A.24. In the draft legislation sent to Congress in July, we proposed the specific factors that the Federal Reserve must consider when determining whether an individual financial firm is a Tier 1 FHC. Our proposed legislation defines a Tier 1 FHC as a financial firm whose material financial distress could pose a threat to financial stability or the economy during times of economic stress. Our proposed legislation requires the Fed to designate U.S. financial firms as Tier 1 FHCs based on an analysis of the following factors:

- the amount and nature of the company's financial assets;
- the amount and types of the company's liabilities, including the degree of reliance on short-term funding;
- the extent of the company's off-balance sheet exposures;
- the extent of the company's transactions and relationships with other major financial companies;
- the company's importance as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the financial system;
- the recommendation, if any, of the Financial Services Oversight Council.

Q.25. *Expertise of the Fed*—Secretary Geithner, the Administration's Proposal chooses to grant the Fed authority to regulate systemic risk because it "has the most experience" to regulate systemically significant institutions. I believe this represents a grossly inflated view of the Fed's expertise. Presently, the Fed regulates primarily bank holding companies and State banks. As a systemic risk regulator, the Fed would likely have to regulate insurance companies, hedge funds, asset managers, mutual funds and a variety of other financial institutions that it has never supervised before.

Since the Fed lacks much of the expertise it needs to be an effective systemic regulator, why could not the responsibility for regu-

lating systemic risk just as easily be given to another or a newly created entity?

A.25. We are not proposing that the Federal Reserve act as a systemic risk regulator. In critical markets, like those for securities and derivatives, the SEC and CFTC will play lead roles. The bank regulators all play crucial roles as prudential supervisors of banks. The Financial Services Oversight Council will have the authority and responsibility to identify emerging risks to the financial system and will help facilitate a coordinated response. We have proposed that the Federal Reserve act as the consolidated supervisor of the largest and most interconnected financial firms. The Federal Reserve has broad expertise in supervising financial institutions involved in diverse financial markets through the exercise of its current responsibilities as the supervisor of bank and financial holding companies. We are confident that it can acquire expertise where needed to oversee the supervision of Tier 1 Financial Holding Companies that do not own a depository institution. As noted above, the potential extension of its consolidated supervision authority to some nonbanking financial institutions represents an evolution in the Federal Reserve's responsibilities.

Q.26. *Skin-in-the-Game*—Secretary Geithner, your proposal would require that mortgage originators maintain an unhedged 5 percent stake in securitized loans.

Will the administration adopt the same position with respect to government programs that assist borrowers in obtaining mortgages and require increased down payment requirements and other such measures to increase "skin-in-the-game?"

A.26. One of the key problems that the financial system experienced in the buildup to the current crisis, was a breakdown in loan underwriting standards—especially in cases where the ability to sell loans in a secondary market allowed originators and securitizers to avoid any long-term economic interest in the credit risk of the original loans. We are proposing that securitizers or originators retain up to a 10 percent stake in securitized loans to align their interests with those of the ultimate investor in those loans. This directly addresses the incentives of originators and securitizers to consider the performance of the underlying loans after asset-backed securities were issued. A family buying a home is in a different position from a loan originator or securitizer. The household faces substantial tangible and intangible costs if it is forced to move. Our proposal would not require home owners to increase their down payment. Also our proposal specifically gives regulators authority to exempt government-guaranteed loans from the skin-in-the-game requirement.

Q.27. *Insurance Regulation*—Secretary Geithner, the Proposal states that the Administration will support measures to modernize insurance regulation, but fails to offer a specific plan. While we all recognize the difficulties involved in modernizing insurance regulation, the problems with AIG's insurance subsidiaries and the fact that several insurers needed TARP money demonstrates that we need to reconsider how we regulate insurance companies.

Will systemically significant insurance companies be regulated by the Fed?

If so, will this effectively require the Fed to act as a Federal insurance regulator so that it can properly supervise the company?

Does the Fed have the necessary expertise in insurance to regulate an insurance company?

Would it be more efficient to establish a Federal insurance regulator that can specialize in regulating large insurance companies?

A.27. Under the Administration's proposals, all firms designated as Tier 1 Financial Holding Companies (Tier 1 FHCs) will be subject to robust, consolidated supervision and regulation. Tier 1 FHCs will be regulated and supervised by the Board of Governors of the Federal Reserve System (Board). Consolidated supervision of a Tier 1 FHC will extend to the parent company and to all of its subsidiaries—regulated and unregulated, U.S. and foreign. This could include an insurance company, if it or its parent were designated as a Tier 1 FHC.

For all Tier 1 FHCs, functionally regulated subsidiaries like insurance companies will continue to be supervised and regulated by their current regulator. However, the Federal Reserve will have a strong oversight role, including authority to require reports from and conduct examinations of a Tier 1 FHC and all its subsidiaries, including insurance companies.

We believe that the current insurance regulatory system is inefficient and that there is a need for a Federal center for expertise and information on the insurance industry. The Administration has proposed creating an Office on National Insurance (ONI) to develop expertise, coordinate policy on prudential aspects of international insurance matters, and consult with the States regarding insurance matters of national and international importance, among other duties. The ONI will receive and collect data and information on and from the insurance industry and insurers, enter into information-sharing agreements, and analyze and disseminate data and information, and issue reports for all lines of insurance except health insurance. This will allow the ONI to identify the emergence of problems within the insurance industry that could affect the economy as a whole.

In addition, our proposal lays out core principles to consider proposals for additional reforms to insurance regulation: Increased consistency in the regulatory treatment of insurance, including strong capital standards and consumer protections, would enhance financial stability, result in real improvements for consumers and also increase economic efficiency in the insurance industry. One of our core principles for insurance regulation is to increase national uniformity of insurance regulation through either a Federal charter or effective action by the States. We look forward to working with you and others in the Congress on this important issue.

Q.28. *Resolution Plans*—Secretary Geithner, under your proposal, systemically significant firms would be required to devise their own plans for rapidly resolving themselves in times of financial distress.

Will firms be able to incorporate into their death plans the expectation of taxpayer money to cover wind-down expenses?

A.28. No. That is the opposite of what we have in mind. We propose that the Federal Reserve should require each Tier 1 FHC to prepare and periodically update a credible plan for the rapid reso-

lution of the firm in the event of severe financial distress. Such a requirement would create incentives for the firm to better monitor and simplify its organizational structure and would better prepare the government, as well as the firm's investors, creditors, and counterparties, in the event that the firm collapsed. The Federal Reserve should review the adequacy of each firm's plan on a regular basis.

It would not be appropriate for firms to incorporate in such a plan the expectation of taxpayer money to cover wind-down expenses. As I have stated elsewhere in my responses to these questions for the record, identification as a Tier 1 FHC does not come with any commitment of government support. Moreover, any government support through our proposed special resolution regime would be available only in extraordinary circumstances when financial stability is at risk and only upon the agreement of three different government agencies. In most circumstances, bankruptcy would remain the dominant tool for handling the failure of a financial company.

Q.29. *Citigroup*—Secretary Geithner, you mentioned AIG and Lehman as being examples of untenable options for firms nearing failure during a financial crisis. I would add Citigroup to that list of untenable options.

As you surveyed the landscape to understand the types of scenarios that might have to be handled by the new resolution authority that you propose, are there any entities that would still require *ad hoc* solutions as Lehman, AIG, and Citigroup did?

A.29. Our proposals are designed to provide a comprehensive set of tools to address the potential disorderly failure of any bank holding company, including Tier 1 FHCs, when the stability of the financial system is at risk. It is important to note that after the TARP purchase authority expires this year, the government will lack the effective legal tools that it would need to adequately address a similar situation to that which we have seen in the past 2 years.

We believe that our comprehensive regulatory reform proposals would provide the government with the tools necessary to wind down any large, interconnected highly leveraged financial firm if such a failure would threaten financial stability.

Q.30. *Accounting Standards*—Secretary Geithner, among the changes recommended by your proposal are changes in accounting standards.

What is the appropriate role of the administration in directing the substantive determinations of an independent accounting standard setter?

A.30. It is critical that the FASB be fully independent in carrying out its mission to establish accounting and financial reporting standards for public and private companies. The health and soundness of capital markets depend critically on the provision of honest and neutral accounting and financial reporting, not skewed to favor any particular company, industry, or type of transaction or purposefully biased in favor of regulatory, social, or economic objectives other than sound reporting to investors and the capital markets. Governmental entities with knowledge and responsibility for

the health of capital markets have an interest and expertise in maintaining the health of America's capital markets. These entities include the SEC, which has specific oversight of disclosure for publicly held firms, the Public Company Accounting Oversight Board, which is tasked with overseeing the auditors of public companies, and other financial regulators, which have oversight over the soundness of the entities they regulate.

Q.31. *SEC–CFTC Merger*—Secretary Geithner, the proposal acknowledges the need for harmonization between the SEC and CFTC, but stops short of merging the two agencies. Instead, you direct the agencies to work their differences out among themselves and report back in September.

Given the tortured history of compromise between the SEC and CFTC, why do you anticipate that the two agencies can come to agreement in a matter of months?

Wouldn't a merger of the agencies be a better way to force them to work out their differences?

A.31. In the last few months, the SEC and the CFTC have made great progress towards eliminating their differences. Treasury worked closely with the SEC and CFTC to propose a comprehensive framework for regulation of derivatives that is consistent across both SEC and CFTC jurisdiction. In addition, the SEC and CFTC held joint public hearings in early September to identify issues in the process of harmonization and to collect public comment on the process. The SEC and CFTC have produced a joint report on reducing differences in their two frameworks for regulation.

We considered whether to merge the SEC and CFTC. At bottom, however, we are focused on the substance of regulation, not the boxes and the lines. In terms of substance, the most necessary reform is to harmonize futures and securities regulation between these entities, and the SEC and CFTC have begun a process to accomplish that.

Q.32. *Broker-Dealers and Investment Advisors*—Secretary Geithner, the Administration's proposal recommends applying a fiduciary standard to broker-dealers that offer investment advice.

How will this change affect the way FINRA regulates broker-dealer activities?

Do you anticipate recommending a self-regulatory organization for investment advisors or eliminating FINRA as an SRO for broker-dealers?

A.32. Treasury's report to Congress advocates a fiduciary standard for investment advisers and broker-dealers offering investment advice. We have not taken a position with respect to the role of SROs.

Q.33. *Barriers to Entry*—Secretary Geithner, in many ways the Administration's proposal rewards failure. The Fed, which fumbled the responsibilities it had, will get more responsibility. The SEC, which failed to properly oversee the advisors registered with it, will have more registered advisors. And some of the biggest financial firms, the ones that made so many miscalculations with respect to risk management, stand to benefit from the additional layers of regulatory red-tape that your system creates. Yet in your state-

ment, you state that the changes you are proposing reward innovation, often the product of smaller firms.

What specific changes in your proposal make the environment more conducive to small, innovative firms?

A.33. Under existing law, financial instruments with similar characteristics may be designed or forced to trade on different exchanges that are subject to different regulatory regimes. Harmonizing the regulatory regimes would remove such distinctions and permit a broader range of instruments to trade on any regulated exchange. For example, we propose the harmonization of futures and securities regulation. By eliminating jurisdictional uncertainties and ensuring that economically equivalent instruments are regulated in the same manner, regardless of which agency has jurisdiction, our proposals will foster innovation resulting from competition rather than the ability to evade regulation.

Permitting direct competition between exchanges also would help ensure that plans to bring OTC derivatives trading onto regulated exchanges or regulated transparent electronic trading systems would promote rather than hinder competition. Greater competition would make these markets more efficient and create an environment more conducive to the most innovative participants.

Innovation is advanced by promoting competition among firms and between financial products. By eliminating arbitrary jurisdictional differences and creating a regulatory regime that is stable and promotes transparency, fairness, accountability, and access, our proposals will increase competition and reward innovation.

Q.34. *Bank of America–Merrill*—Secretary Geithner, last year, Bank of America contemplated not going forward with a merger with Merrill Lynch, but was strongly exhorted by the Fed and Treasury to proceed with the merger.

Did you play a role in deliberations about how to handle the Bank of America–Merrill merger?

If the Administration's proposed changes were in place, would the Fed and Treasury have had any additional tools in their arsenal to deal with the potential fallout of the failed merger that would have made it unnecessary to exercise a heavy hand behind the scenes to force the merger to close?

A.34. After President Obama advised me that I would be his nominee for Treasury Secretary, I no longer participated in policy decisions regarding the Merrill-Lynch situation, including a possible merger with Bank of America. I was, however, kept apprised of developments involving the merger in my role as President of the NYFED. Consequently, I was not involved in policy decisions regarding Bank of America potentially exercising the materially adverse change clause and not going forward with the merger.

While I will not comment on the specifics of the Bank of America–Merrill Lynch merger, it is clear that the government lacked the tools it needed during this crisis to provide for an orderly resolution of a large, nonbank financial firm whose failure could threaten financial stability.

That is why we have proposed a special resolution regime for extraordinary circumstances and subject to high procedural and substantive hurdles to fill this gap. Under our proposal, the govern-

ment would have the ability to establish a receivership for a failing firm. The regime also would provide for the ability to stabilize the financial system as a result of a failing institution going into receivership.

In addition, the receiver of the firm would have broad powers to take action with respect to the financial firm. For example, it would have the authority to take control of the operations of the firm or to sell or transfer all or any part of the assets of the firm in receivership to a bridge institution or other entity. That would include the authority to transfer the firm's derivatives contracts to a bridge institution and thereby avoid termination of the contracts by the firm's counterparties (notwithstanding any contractual rights of counterparties to terminate the contracts if a receiver is appointed).

Q.35. *Multiple Banking Regulators*—The administration outline states "similar financial institutions should face the same supervisory and regulatory standards, with no gaps, loopholes, or opportunities for arbitrage." Your plan envisions a national banking regulator that combines or eliminates many of the various types of banking charters such as thrifts, ILCs, and credit card banks. Your plan, however, seeks to eliminate only one regulator, the Office of Thrift Supervision, while adding one more Federal regulator solely for consumer protection. Thus the total number of bank regulators remains the same.

Why did you decide to leave the Federal Reserve and the FDIC as the primary supervisor of some commercial banks? If the desire is to achieve more accountability from our regulatory system why not consolidate the commercial banking regulatory structure into one Federal and one State Charter?

A.35. Our proposals for structural reform of our regulatory system are focused on eliminating opportunities for regulatory arbitrage. Most importantly, we address the central source of arbitrage in the bank regulatory environment by proposing the creation of a new National Bank Supervisor through the merger of the Office of Thrift Supervision and the Office of the Comptroller of the Currency. These agencies granted Federal banking charters whereas the FDIC and Federal Reserve have oversight regarding charters granted by the States. As such, we are reducing the potential for arbitrage regarding Federal charters. In addition, by recommending closing the loopholes in the legal definition of a "bank," we also make sure that no company that owns a depository institution escapes firm-wide supervision. Moreover, our proposals on preemption and examination fee equalization would substantially reduce arbitrage opportunities between national and State charters.

Q.36. *Resolution Regime*—Secretary Geithner, if Lehman had been resolved under your proposed resolution regime, how would Lehman's foreign broker-dealer have been handled?

A.36. The financial regulatory reform initiative that we are proposing is comprehensive. Under the plan, all subsidiaries of Tier 1 FHCs, including foreign entities, will be subject to consolidated supervision. The focus of this supervision is on activities of the firm as a whole and the risks the firm might pose to the financial system.

First, United States Tier 1 FHCs will be required to maintain and update a credible rapid resolution plan, to be used to facilitate the resolution of an institution and all of its subsidiaries (U.S. and foreign) in the event of severe financial distress. This requirement will provide incentives for better monitoring and simplification of organizational structures, including foreign subsidiaries, so that the government and the entity's customers, investors, and counterparties may be better prepared in the event of firm collapse. Second, in the event that the Tier 1 FHC is resolved through the proposed special resolution regime, the appointed receiver would coordinate with foreign authorities involved in the resolution of subsidiaries of the firm established in a foreign jurisdiction. This is the same process the FDIC would use for failing banks with foreign subsidiaries.

Q.37. Would U.S. taxpayer funds have been used to satisfy foreign customer liabilities?

A.37. The resolution regime that we are proposing is not designed to replace or augment existing customer protections, either domestically or internationally. We would expect existing programs to protect insured depositors, customers of broker-dealers, and insurance policyholders to continue. The resolution regime would allow the receiver to create a bridge institution in order to more effectively unwind the firm while protecting financial stability and it is possible that liabilities held by foreign counterparties could be put into the bridge institution. However, the purpose of the special resolution regime would be to unwind, dismantle, restructure, or liquidate the firm in an orderly way to minimize costs to taxpayers and the financial system. All holders of Tier 1 and Tier 2 regulatory capital would be forced to absorb losses, and management responsible for the failure would be fired. If there are any losses to the government in connection with the resolution regime, these will be recouped from large financial institutions in proportion to their size.

Q.38. *Over-the-Counter Derivatives*—Secretary Geithner, the Administration's plan does not provide much detail about the Administration's views as to the proper allocation of responsibility with respect to over-the-counter derivatives between the Securities and Exchange Commission and the Commodity Futures Trading Commission.

As you devise your recommendations for allocating regulatory responsibility over derivatives, how are you taking into account the importance of interest rate swaps and currency swaps to the debt securities markets.

A.38. As a general matter, our plan allocates responsibility for over-the-counter derivatives (swaps) between the SEC and CFTC consistent with how existing law allocates responsibility over futures. More specifically, we provide the SEC with authority to regulate swaps based on a single security or a narrow-based securities index; we provide the CFTC with authority to regulate swaps based on broad-based securities indices and other commodities (including interest rates, currencies, and nonfinancial commodities). Given the functional similarities between swaps and futures, we believed that it was important to have the swaps regulatory jurisdictions parallel

those of the futures markets. In addition, to ensure that all classes of swaps face similar constraints, we have required the SEC and CFTC to issue joint rules on the regulation of swaps, swap dealers, and major swap participants.

In designing our swaps framework, we took into account the importance of interest rate swaps and currency swaps to the debt markets. We believe that our proposals will enhance the transparency and stability of those markets. Although our proposals require central clearing of standardized derivatives, we have preserved the ability of businesses to hedge their interest rate and currency risks through customized derivatives in appropriate cases.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM TIMOTHY GEITHNER

Q.1. If the Federal Reserve is given more regulatory responsibilities, how can we ensure that Congress can fully exercise its oversight role while also maintaining the Federal Reserve's independence over monetary policy?

A.1. Congress has exercised vigorous oversight over Federal Reserve regulation and supervision for decades and we are not aware of any evidence that this oversight has infringed on the independence of monetary policy. Congress can and does call hearings on supervision and regulation where the Federal Reserve and other agencies are called to testify. Moreover, all of the Federal Reserve's supervisory and regulatory functions are subject to review by the GAO. Recent GAO reports on the Federal Reserve and other banking regulators have included assessments of capital rules, *http://www.gao.gov/new.items/d08953.pdf*; consolidated supervision, *http://www.gao.gov/new.items/d07154.pdf*; and oversight of risk management systems at major banking organizations, *http://www.gao.gov/ncw.items/d09499t.pdf*. We believe that this oversight can and should continue and we do not perceive a threat to the independence of monetary policy.

Q.2. We have spoken about concerns I have about private equity acquisitions of banks. As you know I feel strongly that there should be a consistent and carefully thought out policy that allows us to take advantage of the capital that private equity has to offer, while at the same time include strong protections to ensure that commercial interests of private equity and other firms do not threaten the safety and soundness of institutions or the overall stability of our Nation's financial system.

What is the status of efforts to develop a consistent policy among regulators in this area?

A.2. The staff of the Department of the Treasury (Treasury) has consulted with staff of the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS), respectively, regarding the standards used to assess proposals by private equity investors (Investors) for controlling investments in banking organizations. Even though these standards have common features, each agency supervises different types of banking organizations and must administer separate laws with distinct mandates. As these

agencies continue to develop standards, as summarized below, Treasury is mindful of the need to establish consistent policies for promoting access to capital, ensuring appropriate supervisory oversight over banking firms, aligning the incentives of investors with the long-term health of banking organizations, and strengthening the wall between banking and commerce. We will be working through the President's Working Group on financial markets (and in the future through the Financial Services Oversight Council if Congress creates one as part of regulatory reform) on these matters.

The Federal Banking Agencies Continue To Develop Policies for Investors

The Board

In September 2008, the Board adopted a policy statement regarding noncontrolling investments in banks and bank holding companies under the requirements of the Bank Holding Company Act (BHCA). As individual transactions may present unique structures, the Board addresses controlling investments in banks and bank holding companies on a case-by-case basis. The Board staff has advised Treasury that, in general, various proposals by Investors to establish a fund to acquire control of a banking organization have not appeared to satisfy the requirements of the BCHA because the Investors also control funds that make commercial investments. Although the Board has permitted a few groups of investors to establish bank holding companies notwithstanding their control of other funds with commercial investments, the Board has not recently approved such a transaction. According to the Board staff, in each of those prior cases, the decision to permit the bank holding company to be affiliated with a commercial firm was limited to the particular circumstances surrounding the investment and the Investors, such as ownership and control of the bank holding company by individuals, as opposed to private equity organizations.

The OTS

The OTS has approved private equity investments in thrifts under the Home Owners' Loan Act (HOLA). In considering these investments and new proposals, OTS staff has advised that the agency is focused on balancing the needs to allow investments in thrifts and thrift holding companies, as permitted by the HOLA, with prudential measures designed to assure the safety and soundness of those institutions. For example, OTS indicated that in January 2009 the OTS approved the acquisition of Flagstar Bank, FSB by eight newly formed private equity funds and, among other measures, obtained commitments by the Investors barring the Investors from exercising control over the management, policies, or business operations of the thrift organization and restricting transactions between their affiliates and the thrift organization. In this regard, the commitments obtained by the OTS were similar to commitments obtained by the Board in other transactions by Investors approved by the Board. Staff of the OTS has advised Treasury that, subject to appropriate prudential measures, certain controlling investments in thrifts and thrift holding companies by Investors, in-

cluding Investors that also maintain controlling commercial investments, may satisfy the requirements of the HOLA.

The FDIC

The FDIC issued final guidance in August establishing principles that would apply to certain applications to acquire failed banks (FDIC Policy Statement) by Investors. Under the FDIC Policy Statement, certain Investors will have to satisfy requirements regarding: capital commitments; cross guarantees; transactions with affiliates; limits on entities based in secrecy law jurisdictions; continuity of ownership; special bid limits on insiders; and disclosure. In particular, Investors will be required to ensure that the acquired depository institution has a minimum Tier 1 leverage ratio of 10 percent for at least 3 years, and thereafter is "well capitalized" during the remaining period of their ownership, and generally will be prohibited from selling or otherwise transferring the securities of the holding company or depository institution for a 3-year period. In addition, the FDIC Policy Statement makes Investors holding 10 percent or more of the equity of a bank or thrift in receivership ineligible to be a bidder on that failed depository institution. Finally, the FDIC Policy Statement states that structure for owning depository institutions where the beneficial ownership is not easily ascertained—so-called "silo" structures—will not be approved.

Treasury Is Working To Promote Consistent Policies

Private equity investments in banking organizations raise potentially competing considerations. These investments can strengthen our banking system by providing an important component of private capital and spurring the timely resolution of failed depository institutions. On the other hand, these investments can entail risks and raise important policy issues relating to the supervisory oversight necessary to protect the safety and soundness of banks, such as aligning the incentives of investors with the long-term health of banks and strengthening the policy of separating banking from commerce. Treasury is currently reviewing developments in this area, and will continue to work through the President's Working Group on Financial Markets (and in the future through the Financial Services Oversight Council if Congress creates one as part of regulatory reform) to engage independent banking agencies to develop consistent policies regarding private equity investments in insured depository institutions.

Q.3. Are there legislative changes that are required to adequately address this issue?

A.3. The Administration has recommended the closing of certain statutory loopholes that historically have permitted the mixing of banking and commerce and evasion of supervision under the Bank Holding Company Act. The banking agencies have authority under current law to balance the Deed for capital in the system with the need for appropriate safety and soundness supervision with respect to private equity investments. We would be happy to discuss the issue with you, including possible legislative changes.

Q.4. As you know, I have urged Treasury to use its leverage to sell, exercise, or hold warrants after financial institutions repay TARP funds to ensure the best return for taxpayers.

What are Treasury's plans with respect to handling the warrants of institutions that repay their TARP funds?

Will there be a clear written set of policies and procedures on this?

A.4. In December 2009, Treasury conducted public auctions for its warrants in Capital One Financial Corporation, JPMorgan Chase & Co., and TCF Financial Corporation. Each of these banks had fully repurchased Treasury's preferred stock investment. The auctions were conducted as modified "Dutch" auctions registered under the Securities Act of 1933, in a format where qualified bidders may submit one or more independent bids at different price-quantity combinations and the warrants will be sold at a uniform price that clears the market.

Proceeds to Treasury from the auction of its warrants in Capital One Financial Corporation, JPMorgan Chase & Co., and TCF Financial Corporation, were approximately $148.73 million, $950.32 million, and $9.59 million, respectively, with net receipts to Treasury after underwriting fees and selling expenses of approximately $146.50 million, $936.06 million and $9.45 million, respectively. Treasury expects to conduct similar auctions in the future.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR AKAKA FROM TIMOTHY GEITHNER

Q.1. *Mandatory Arbitration Clause Limitations*—Mr. Secretary, please provide the written response that you mentioned during the hearing on why the Consumer Financial Protection Agency should have the authority to restrict or ban mandatory arbitration clauses.

A.1. Treasury's proposed legislation authorizes the CFPA by rule to prohibit or impose conditions or limitations on pre-dispute mandatory arbitration clauses if the Agency finds that such prohibition, conditions, or limitations are in the public interest and for the protection of consumers.

Many financial products and services providers require their customers to agree to contracts containing provisions to arbitrate all disputes. Although arbitration may be a reasonable option for many consumers to accept after a dispute arises, mandating a particular venue and up-front method of adjudicating disputes—and eliminating access to courts—may unjustifiably undermine consumer interests. There are several aspects of mandatory pre-dispute arbitration that have raised concern. Many consumers do not know that they often waive their rights to trial when signing contracts for financial products. Arbitrators are private parties dependent on large firms for repeat business, which may give rise to conflicts of interest.

Rather than banning pre-dispute mandatory arbitration in the legislation, our proposal gives the Agency the power to study it and, if warranted, impose limitations or ban it to ensure fairness for consumers. In addition, under our proposal, even if mandatory arbitration were banned, parties would still be free to agree to arbitration once a dispute has arisen. Post-dispute arbitration is much

more likely to be a fair process because consumers can evaluate the arbitration process in light of the potential or actual dispute before agreeing to such an arbitration process.

Q.2. *Financial Literacy*—Mr. Secretary, what specific financial literacy responsibilities will the Consumer Financial Protection Agency have?

A.2. We believe that financial education is an important component of consumer protection and financial stability. Thus, the CFPA will play an important role in efforts to educate consumers about financial matters, to improve their ability to manage their own financial affairs. and to make their own judgments about the appropriateness of certain financial products. Once established, Treasury anticipates that the CFPA will include an Office of Financial Literacy that will work to promote consumer financial education. We also anticipate that the Director of the CFPA will be a member of the Financial Literacy and Education Commission established by the Financial Literacy and Education Improvement Act (20 U.S.C. 9701 *et seq.*), and that the CFPA will coordinate and work closely with the FLEC.

Q.3. *Promoting Access to Mainstream Financial Services*—Mr. Secretary, I remain concerned that consumer access to mainstream financial services remains limited in underserved communities. The proposal indicates that a critical part of the Consumer Financial Protection Agency's mission will be promoting access to financial services. Other than rigorous enforcement of the Community Reinvestment Act, what will the CFPA do to promote access to mainstream financial services and ensure that the financial service needs of communities are being met?

A.3. As part of a legislative requirement to consider the costs and benefits of any new regulation, the CFPA will analyze how regulations affect consumers' access to financial services. Under the Administration's proposal, ensuring access to traditionally underserved consumers and communities and ensuring ample room for innovation would be a core part of the CFPA's mission. As you mention, our proposed legislation gives the Agency authority to rigorously enforce the Community Reinvestment Act (CRA) in order to ensure that depository institutions meet the credit needs of the communities in which they operate. In addition, it requires the CFPA to establish a community affairs unit with the mission of providing information, guidance, and technical assistance regarding the provision of consumer financial products or services to traditionally underserved consumers and communities. The proposed legislation would also require the CFPA to create a research unit that will research, analyze, and report on market developments, disclosures and communications, consumer understanding of financial products, and consumer behavior. This unit's work will inform regulatory and market innovation that will expand access to financial services to the communities that need it most.

Q.4. *Financial Budget and Staffing for the CFPA*—How large of a budget and how many staff members will be needed to ensure that the Consumer Financial Protection Agency will be able to effectively educate, protect, and empower consumers?

A.4. The CFPA will require a budget and staff that are commensurate with its responsibilities, which include both existing functions performed by the current financial services regulators, as well as expanded authority to strengthen protections where they have been weak, particularly regarding the nonbank sector. Strong, stable funding will ensure that the agency can establish, monitor, and enforce high standards for consumers across the financial services marketplace.

The CFPA's budget will include the resources used by the existing regulators to carry out their financial consumer protection functions, which will all be transferred to the new agency. The agencies that will transfer functions to the CFPA include the Federal Reserve Board and Federal Reserve Banks, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Federal Trade Commission (FTC), and the Department of Housing and Urban Development (HUD). In addition to these resources, the CFPA will need to hire staff to provide a level playing field by extending the reach of Federal oversight to the nonbank providers of consumer financial products and services.

We do not yet have an estimate of what amount will be necessary to fund the CFPA. We are in the process of gathering information on the resources expended from each of the agencies where funds will be transferred, and estimating the additional resources that will be required for the functions that are not being performed now, including supervision of nonbank financial companies that provide consumer financial products or services.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR KYL FROM TIMOTHY GEITHNER

Q.1. Anecdotal reports suggest that the regional offices of Federal bank regulators are not applying regulatory standards uniformly across the Nation, may not be adequately coordinating with their State counterparts, and are in some cases advising banks not to make loans that would otherwise be profitable.

Are you aware of this problem?

If so, what can be done to facilitate coordination among the regional offices of our Federal regulators to ensure standards are applied uniformly?

What role would State bank regulators play under the Administration's reform proposal?

How can States be better integrated into a seamless regulatory scheme in order to leverage local regulators' unique knowledge about their own marketplace?

A.1. Federal bank regulators seek to apply regulatory standards uniformly across their organizations. However, this does present challenges in that some degree of examiner discretion, based on local knowledge and other factors, also plays an important role. Moreover, regional economic differences may necessitate some flexibility in the application of requirements.

The Administration's regulatory reform proposal preserves the role of State chartered banks and State supervision. Today, Federal

and State banking regulators coordinate their examination programs and share information. In 2006, the State Liaison Committee (SLC) was added to the Federal Financial Institutions Examination Council (FFIEC) as a voting member. The SLC includes representatives from the Conference of State Bank Supervisors, the American Council of State Savings Supervisors, and the National Association of State Credit Union Supervisors. The FFIEC is a formal interagency body designed to prescribe uniform principles, standards, and report forms for the Federal examination of financial institutions by the banking regulators and to make recommendations to promote uniformity in the supervision of financial institutions. Having State regulators represented on the FFIEC should help to leverage local knowledge.