TESTIMONY OF
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SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ON:

"PERSPECTIVES ON REGULATION OF SYSTEMIC RISK
IN THE FINANCIAL SERVICES INDUSTRY"

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I. Introduction

Chairman Frank, Ranking Member Bachus, members of the Committee:

My name is Tim Ryan and I am President and CEO of the Securities Industry and Financial Markets Association ("SIFMA").[1] Thank you for your invitation to testify at this important hearing. My testimony will detail SIFMA's views on a financial markets stability regulator, including the mission, purpose, powers and duties of such a regulator.

As we all know, financial markets across the globe have experienced severe dislocations in the last several months. Congress has aggressively responded to these challenges in the United States by passing sweeping

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[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

legislation, including the Emergency Economic Stabilization Act of 2008 (the "EESA"), the Housing and Economic Recovery Act of 2008, and the American Recovery and Reinvestment Act of 2009. Congress has rightly recognized, however, that addressing the immediate crisis is only half the battle. Improvements can be made to our current regulatory model for financial services which can help us avoid such crises in the future. We recognize that this is a moment in our history where such efforts are essential.

SIFMA stands ready to be a constructive voice in this critically important public policy dialogue to restore confidence in the global financial system. Our members understand the value that a well-designed and implemented regulatory system brings to minimizing systemic risk. We believe that a global effort is required to develop such a regulatory system with common principles that limit regulatory arbitrage between and among nations.

II. Financial Markets Stability Regulator

Systemic risk has been at the heart of the current financial crisis. While there is no single, commonly-accepted definition of systemic risk, we think of "systemic risk" as the risk of a systemwide financial crisis characterized by a significant risk of the contemporaneous failure of a substantial number of financial institutions or of financial institutions or a financial market controlling a significant amount of financial resources that could result in a severe contraction of credit in the U.S. or have other serious adverse effects on economic conditions or financial stability. SIFMA has devoted considerable time and resources to thinking about systemic risk, and what can be done to identify it, minimize it, maintain financial stability and resolve a financial crisis in the future.

A regulatory reform committee of our members has met regularly in recent months to consider these issues, and to develop a workable proposal to address them. We have sponsored roundtable discussions with former regulators, financial regulatory lawyers and our members, as well as other experts, policymakers and stakeholders to develop solutions to the issues that have been exposed by the financial crisis and the challenges facing our financial regulatory architecture.

A. We Support the Proposal to Establish a Financial Markets Stability Regulator

Through this process, we have identified a number of questions and trade-offs that will confront policymakers in trying to mitigate systemic risk. There is an emerging consensus among our members that we need a financial markets stability regulator as a first step in addressing the challenges facing our overall financial regulatory structure. Other leading commentators have reached a similar conclusion. The G30, in its report on financial reform, supports a central body with the task of promoting and maintaining financial stability, and the Treasury, in its blueprint, also has supported a market stability regulator. More recently, Federal Reserve Chairman Ben Bernanke has identified the creation of a systemic risk authority as a key element of a strategy to reform the financial regulatory system.

We are realistic in what we believe a financial markets stability regulator can accomplish. Although the financial markets stability regulator may not be able to identify the causes or prevent the occurrence of every financial crisis in the future, by ensuring that a single regulator has clear responsibility, broad aggregated information (across various financial institutions), and the supervisory tools needed to minimize these risks when identified, we believe this will substantially improve the current system. At present, no single regulator (or collection of coordinated regulators) has the authority or the resources to collect information system-wide or to use that information to take corrective action in a timely manner across all financial institutions and markets regardless of charter. The financial markets stability regulator will help fill these gaps.

B. Mission of the Financial Markets Stability Regulator

We believe that the mission of the financial markets stability regulator should consist of mitigating systemic risk, maintaining financial stability and addressing any financial crisis. Specifically, the financial markets stability regulator should have authority over all financial institutions and markets, regardless of charter, functional regulator or unregulated status. We agree with Chairman Bernanke that its mission should include monitoring systemic risks across firms and markets, rather than only at the level of individual firms or sectors; assessing the potential for practices or products to increase systemic risk; and identifying regulatory gaps that have systemic impact. One of the lessons learned from recent experience is that sectors of the market, such as the mortgage brokerage industry, can be systemically important, even though no single institution in that sector is a significant player. The financial markets stability regulator should have the authority to gather information from all financial institutions and markets, adopt uniform regulations related to systemic risk, and act as a lender of last resort.

In carrying out its duties, the financial markets stability regulator should coordinate with the relevant functional regulators, as well as the President's Working Group, in order to avoid duplicative or conflicting regulation and supervision. It should also coordinate with regulators responsible for systemic risk in other countries. Although the financial markets stability regulator's role would be distinct from that of the functional regulators, it should have a more direct role in the oversight of systemically important financial organizations, including the power to conduct examinations, take prompt corrective action and appoint or act as the receiver or conservator of such systemically important groups. These more direct powers would end if a financial group were no longer systemically important.

We believe that all systemically important financial institutions that are not currently subject to federal functional regulation, such as insurance companies and hedge funds, should be subject to such regulation. But we do not believe the financial markets stability regulator should play that day-to-day role for those entities. The Investment Company Institute has suggested that hedge funds could be appropriately regulated by a merged SEC and CFTC. We agree with that viewpoint. The collapse of AIG has highlighted the importance of robust insurance holding company oversight. We believe the time has come for adoption of an optional federal insurance charter for insurance companies. We believe that a federal insurance regulator should be established to act as the federal functional regulator of federally chartered insurance companies and possibly some state insurance companies, as well as the consolidated supervisor of insurance company holding companies that are not otherwise subject to federal consolidated supervision. We have also supported increasing the authority of the Municipal Securities Rulemaking Board to create a comprehensive regulatory framework for the municipal market that would extend to financial advisors, investment brokers and other intermediaries in the municipal market. On an ongoing basis, we believe the financial markets stability regulator should identify new players, products or sectors that are systemically important where there are gaps in the regulatory framework, and should be required to notify Congress of such deficiencies where further legislative action is necessary.

In a regulatory system where functional regulation is overlaid by financial stability oversight, how the financial markets stability regulator coordinates with the functional regulators is an important issue to consider. As a general principle, we believe the financial markets stability regulator should coordinate with the relevant federal functional regulators in order to avoid duplicative or conflicting regulation and supervision. For example, the financial markets stability regulator could be required to consult with functional regulators with regard to promulgating and enforcing systemic risk rules. The financial markets stability regulator might require enforcement authority, but should be required to coordinate the use of that authority with the relevant federal functional regulators.

However, in order for the financial markets stability regulator to provide oversight across institutions and markets, it may be necessary to impose an obligation on functional regulators to share supervisory information with the financial markets stability regulator. Also, if federal functional regulators differ with respect to systemic risk issues, the financial markets stability regulator may need to take action to establish consistent rules with respect to systemic risk issues. And though the federal functional regulator would remain the primary regulator of any financial institution within a systemically important financial group, you might also consider whether the financial markets stability regulator should have the authority to override the federal functional regulator with respect to systemic risk issues.

C. Powers and Duties

There are many issues to consider in determining what the powers and duties should be of the financial markets stability regulator. We have identified and analyzed a number of them that we enumerate below.

1. Scope of Authority

The first issue to consider is the scope of authority of the new regulator. To be effective, the authority should probably extend to all financial institutions, markets, products and services. The new regulator should also probably have more direct supervisory power over systemically important financial institutions or groups.

You might want to consider defining certain kinds of institutions, markets, products or services as financial. Such categories should probably include currently unregulated financial institutions, such as hedge funds, private equity funds or others, in addition to regulated financial institutions, such as banks, savings associations, other depository institutions, securities brokers or dealers, insurance companies, securities clearing agencies, derivatives clearing organizations, payment system operators, investment companies, investment advisers, commodity pool operators, commodity trading advisors or futures commission merchants. You might define markets broadly to include securities or futures markets, over-the-counter financial markets, electronic communications networks and alternative trading systems. You might also consider whether to give the financial markets stability regulator discretionary authority to declare other entities, markets, products or services to be financial or to exempt any financial institutions, markets, products or services from coverage, and what limits to put on those discretionary authorities.

You might also want to consider taking a similar approach to defining what constitutes a systemically important financial institution or group. Certain types of entities might be defined as systemically important, including primary dealers, securities clearing agencies, derivatives clearing organizations and payment system operators. You might also want to consider whether to give the financial markets stability regulator discretionary authority to declare any other financial institutions to be systemically important, and what limits to put on that authority. You might also want to consider whether the financial markets stability regulator should have discretionary authority to determine that an institution that was once designated as systemically important should no longer be classified that way if it is no longer systemically important.

2. Level Playing Field

In defining the powers and duties of the financial markets stability regulator, it will be important to maintain a level playing field between systemically important and other financial institutions. If systemically important financial groups are regulated more heavily than other financial institutions, this will perpetuate or create new opportunities for regulatory arbitrage. Any activities that are regulated more heavily when conducted by a systemically important institution will simply migrate to the relatively less regulated institutions or flow off-shore. Instead of reducing overall risk in the system, this approach would simply shift risk from one group to another. On the other hand, systemically important financial groups could be perceived to benefit from a "too big or too complex to fail" policy, which could result in a funding or other advantage over other financial institutions and an unacceptable level of moral hazard. Any legislation creating a financial markets stability regulator should try to be as neutral as possible between the two groups.

3. Information Gathering

You might consider giving the financial markets stability regulator the authority to gather information from all U.S. financial institutions and markets in order to identify systemic risk and maintain financial stability. You might also consider whether this authority should apply to all financial institutions, regardless of charter, and regardless of whether they are currently functionally regulated or not. The financial markets stability regulator will need information necessary to form and maintain a picture of the overall systemic risks in the U.S. financial system.

4. Uniform Systemic Risk Rules

While some commentators have suggested that the regulatory powers of the financial markets stability regulator be focused exclusively on systemically important financial groups, we believe this would be a mistake. If the authority of the financial markets stability regulator is limited to systemically important financial groups, any efforts to identify and control systemic risk will simply result in shifting the risky activities to other financial institutions or off-shore rather than taking it out of the system or controlling it. Also, the financial markets stability regulator may identify sectors of the market where individual entities are not systemically important, but which entities in the aggregate can have a significant impact on systemic risk. You should therefore consider giving the financial markets stability regulator the authority to make uniform rules, where applicable, for any class of similarly situated financial institutions, markets, products or services to the extent necessary to reduce systemic risk and promote financial stability.

If you do, you should also consider whether to require the financial markets stability regulator to consult with the relevant federal functional regulators. The goal of such uniform systemic risk rules should not be to unduly burden smaller institutions that would be otherwise only be tangentially touched by the financial markets stability regulator. You might also consider giving a nonexclusive list of examples where the financial stability regulator has authority, such as capital or liquidity rules for any class of similarly situated financial institutions, and risk management and transparency requirements.

5. Information Sharing

The financial markets stability regulator will need to coordinate with the relevant federal functional regulators in order to do its job properly. You should consider imposing an obligation on all functional regulators to share supervisory information with the financial markets stability regulator. It is difficult to see how the financial markets stability regulator will be able to do its job properly unless it has access to supervisory information gathered by all relevant functional regulators.

6. Confidential Supervisory Information

Some of the information gathered by the financial markets stability regulator, especially from otherwise unregulated financial institutions such as hedge funds or private equity funds, may not otherwise be publicly disclosed and may be confidential and proprietary. Such information should be treated as confidential supervisory information and therefore protected by statute against disclosure or loss of privilege, except to the extent it forms part of industry-wide data. Congress might consider reviewing the statutory protections of such information to determine whether they need to be strengthened. Otherwise, there could be legitimate and serious resistance to the financial stability regulator's information gathering powers from some financial institutions.

Similarly, all confidential supervisory information shared among federal regulators should have the same statutory protection. Such information should not lose some or all of its protection because a functional regulator shares it with the financial markets stability regulator, or vice versa. You should consider reviewing the statutory protections governing confidential supervisory information to make sure they are all sufficiently protective.

7. Accountability

Given the scope of authority the financial markets stability regulator might have, it will be important to hold the financial markets stability regulator accountable for implementing its mission. The Congress should consider a robust reporting regime for the financial markets stability regulator including, at a minimum, annual reports to Congress. The financial markets stability regulator might report on (1) the risks to the U.S. financial system, (2) the regulatory measures being taken or that will be taken to address such risks, (3) the costs and benefits of such measures, (4) any adverse effects from such measures on market discipline, and (5) the steps being taken to minimize moral hazard and maximize the benefits of market discipline.

8. International Coordination

International coordination on systemic issues will be critical to avoid cross-border regulatory arbitrage. You should consider giving the financial markets stability a mandate to coordinate with any foreign or international body of regulators on systemic risk issues. The G30 report, for example, strongly encourages enhancing existing mechanisms for international regulatory and supervisory coordination.

9. Technology Platform

Because no U.S. regulator currently has the technology platform necessary to gather, aggregate and mine all the data that might be gathered by the financial markets stability regulator, you should consider giving the financial markets stability regulator a mandate to develop a plan to aggregate the data that currently resides at the different regulated industry utilities or otherwise build the systems necessary to achieve its goals.

10. Enforcement Authority

The financial markets stability regulator will not be able to carry out its mission effectively if it does not have the authority to enforce its rules or orders. Consequently, you should consider giving it enforcement authority similar to what the Federal Reserve has over bank holding companies, including the power to take formal and informal supervisory action against any financial institution or market. The financial markets stability regulator should generally be required to coordinate or defer to any relevant federal functional regulators in bringing enforcement action against any financial institution or market, other than a systemically important financial institution. But you should consider whether to give it override authority with respect to the enforcement of any rule, regulation or order made to reduce systemic risk or promote financial stability if it is not being adequately enforced by the relevant federal functional regulator.

11. Lender of Last Resort

Section 13(3) of the Federal Reserve Act has been the Federal Reserve's tool of choice in providing liquidity and other financial assistance to financial institutions and the market during the current financial crisis. That has been its source of authority for its emergency liquidity facility to primary dealers, its rescue of AIG, the Commercial Paper Funding Facility, the Term Asset-Backed Securities Loan Facility (TALF), its credit support for Fannie and Freddie, its participation in the troubled asset guarantee programs, and most of its other emergency actions during the financial crisis. It would probably be useful to analyze whether Section 13(3) needs to be updated or modernized in any way in light of the lessons learned during the current financial crisis.

12. Consolidated Supervision and Examination Authority

The rest of the issues relate solely to systemically important financial institutions. The financial markets stability regulator is likely to argue that it requires direct consolidated supervisory authority over systemically important financial institutions in order to do its job effectively. You might therefore consider whether to give it the authority to be the consolidated supervisor of systemically important financial groups, much the way the Federal Reserve is currently the consolidated supervisor of bank holding company groups. You might also consider whether this authority should be exclusive at the group level. It may be unfair to subject a systemically important financial group to duplicative and overlapping consolidated supervision. This would not affect the functional regulation of any financial institution within the group, which would remain subject to functional regulation by its federal functional regulator. Although the financial markets stability regulator would ordinarily coordinate with or defer to the functional regulator of any financial institution within the group, you should consider whether the financial markets stability regulator should have the authority to override any such functional regulator on systemic risk issues.

13. Prompt Corrective Action

The federal banking agencies currently have the authority to take a wide variety of correction actions well before an insured bank becomes insolvent. This gives the banking agencies the flexibility to address issues before they turn into a crisis. While having authority is not the same as using it, you might nevertheless consider giving the financial stability regulator similar authority to take prompt corrective action with respect to any systemically important financial institution or group if certain events occur, such as becoming undercapitalized, being in an unsafe or unsound condition or engaging in an unsafe or unsound practice. The trigger events and permissible actions could be modeled on those contained in Section 38 of the Federal Deposit Insurance Act.

14. Resolution Powers

One of the most important gaps exposed during the current financial crisis was the lack of federal resolution powers for systemically important financial institutions or groups. The Federal Deposit Insurance Corporation ("FDIC") has broad powers to act as a conservator or receiver of a failed or severely troubled bank. These powers include the ability to control the process, to repudiate burdensome contracts, to transfer certain assets and liabilities to a bridge bank, and to enter into loss-sharing and other financial assistance arrangements designed to maximize the value of the failed institution to the system. This is the power the FDIC used to resolve WaMu, IndyMac and other thrifts. The Federal

Housing Finance Authority exercised similar powers when it placed Fannie and Freddie into conservatorship.

No similar resolution power was available to the government to resolve Lehman Brothers or AIG. Lehman Brothers was allowed to fail largely because no one was willing to step in to acquire Lehman Brothers before it filed for bankruptcy. AIG was rescued initially with a use of the Federal Reserve's authority under Section 13(3) of the Federal Reserve Act and subsequently by money from the Troubled Asset Relief Program.

The Bankruptcy Code or state insurance insolvency codes may not give the government sufficient control over the resolution of systemically important financial institutions and groups. Instead, you might consider giving the financial markets stability regulator the authority to appoint itself or another federal regulatory agency (including the FDIC) as the conservator or receiver of any systemically important financial institution or group. If you do, you might also consider giving it resolution powers similar to those contained in Sections 11 and 13 of the Federal Reserve Act.

15. Emergency Financial Assistance

Another important gap in the system exposed by the financial crisis is the lack of any regulator with the power to provide emergency financial assistance to any systemically important financial institution or group in order to prevent systemic risk. The FDIC has the power to provide such assistance to banks, but its power does not extend to financial institutions generally or even to bank holding companies. Moreover, it is generally precluded from providing such "open bank" assistance unless it would be less costly to the deposit insurance fund than closing the bank or if necessary to prevent systemic risk. But the FDIC has been very reluctant to expose the deposit insurance fund even to prevent systemic risk. In fact, but for the short-lived assistance promised in the Citi-Wachovia transaction, the FDIC has not agreed to provide any open bank assistance since 1992.

According to public reports, this has created a certain amount of tension among some of the federal agencies during the financial crisis. The agencies most concerned about systemic risk have not always had clear authority or sufficient resources to provide emergency assistance. The agency that did – the FDIC – has been very reluctant to provide it. If Congress decides to create a financial markets stability regulator and give it resolution powers, it might also consider giving it clear authority over the decision whether to provide emergency financial assistance to prevent a systemic crisis. There should be some limits on the exercise of that power to make sure it does not create moral hazard. One proposal might be to require the financial markets stability regulator to consult with the Secretary of the Treasury and the President, before providing emergency financial assistance to a systemically important financial institution.

D. There Are a Number of Options for Who Might Be the Financial Markets Stability Regulator

There are a number of options for who might be the financial markets stability regulator. One option is to create a new independent federal agency, possibly within Treasury. Another option is a panel of regulators such as the President's Working Group. Yet another option is to make the Federal Reserve the financial markets stability regulator.

Each of these options has advantages and disadvantages. Whichever option is selected, the financial markets stability regulator should have the right balance between accountability to and independence from the political process. It needs to have credibility in the markets and with regulators in other countries. It should have the tools necessary to identify systemic risk, take prompt action to prevent a financial crisis and resolve a financial crisis if it occurs. To be truly effective, the financial markets stability regulator would need to have the power to act as the lender of last resort or to provide emergency financial assistance to the markets, and to have prompt corrective action and resolution powers over failed or failing financial institutions that are systemically important.

A new federal agency could be singularly focused on the critical mission of financial stability. It could be structured to avoid conflicts between its role as financial markets stability regulator and other roles such as that of monetary policy authority. It would likely be more accountable to Congress and less independent than the Federal Reserve. But a new regulatory agency would require a large new budgetary appropriation to staff and fund its activities, as well as substantial time to establish, become fully functional and become credible domestically and internationally. Indeed, this entire process could take several years. There are risks in delaying an effective financial markets stability regulator for too long. Finally, a new regulator might not be given enough independence from the political process to provide confidence to the market.

A panel of regulators such as the President's Working Group might bring together more collective expertise than either a new regulator or the Federal

Reserve. But issues of coordination and collective accountability are a concern. This model has the potential to perpetuate the risk of continued gaps, duplication, inefficiency and waste compared to a single oversight body.

Unlike a new regulatory agency, the Federal Reserve already has a window into the overall U.S. and global markets. It has an experienced staff and the ability to expand its resources with revenues from its open market activities. It has a long tradition of independence, giving it essential credibility with the markets. It also has strong credibility with regulators around the world with which the financial markets stability regulator would need to coordinate. Its tool kit includes many of the tools that we believe are essential for the financial markets stability regulator. For example, it already has the ability to act as the lender of last resort and to provide emergency financial assistance during a financial crisis. These tools probably need to be modernized in light of the lessons learned from the financial crisis, but the Federal Reserve already has them and issues concerning coordination with another body in the event of a financial crisis would be avoided. The Federal Reserve also has experience and a credible track record using these tools responsibly and sparingly. Finally, expanding the Federal Reserve's powers to include those of a financial markets stability regulator could be done relatively quickly and would result in a single regulator being accountable for systemic risk across all financial institutions and markets.

The principal arguments against the Federal Reserve boil down to fears about the concentration of too much power and responsibility in the Federal Reserve and concerns about its independence in conducting monetary policy. In addition, the Federal Reserve would still need to coordinate with the functional regulators unless it is also going to take over their powers, which may not be feasible or desirable. Some critics also point out that the Federal Reserve has not been blameless in failing to identify and take corrective action against systemic risk in time to prevent the current financial crisis.

In addition, if the Federal Reserve is the financial markets stability regulator, you might want to consider the breadth of its duties and whether certain other functions should remain with the Federal Reserve. Also, you might want to consider how Congress should supervise and oversee the Federal Reserve in such a role if it is the financial markets stability regulator.

E. International Cooperation and Coordination

The current financial crisis reminds us that markets are global in nature and so are the risks of contagion. To promote investor protection through effective regulation and the elimination of disparate regulatory treatment, we believe that common regulatory standards should be applied consistently across markets. Accordingly, we urge that steps be taken to foster greater cooperation and coordination among regulators in major markets in the U.S., Europe, Asia, and elsewhere around the world. There are several international groups in which the U.S. participates that work to further regulatory cooperation and establish international standards, including IOSCO, the Joint Forum, the Basel Committee on Banking Supervision, and the Financial Stability Forum. Congress should support and encourage the efforts of these groups.

III. Conclusion

Recent challenges have highlighted the necessity of a fundamental review of our regulatory system. SIFMA strongly supports these efforts and commits to be a constructive participant in the process. SIFMA stands ready to assist the Committee as it considers systemic risk and the proposal to create a new federal regulator to be responsible for identifying and controlling systemic risk. We are confident that through our collective efforts, we have the capacity to emerge from this crisis with stronger and more modern regulatory oversight that will not only prepare us for the challenges facing financial firms today and in the future, but also help the investing public meet its financial needs and support renewed economic growth and job creation.