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Reforming Financial Regulation

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It is fashionable today to see the sky falling in on our banking system. We have seen the name "bank" sullied as it is used very broadly. However, the public needs to know that, despite press reports to the contrary, most banks never made a toxic subprime loan, are well capitalized, and are lending. Almost every bank in the country, 97.5 percent according to official figures, meets all of the regulatory standards of being "well capitalized;" about 90 percent are CAMELS rated I or II, meaning that they are of no supervisory concern. The regulators here should make the point to the public that all but very few banks are healthy.

Yet banks have been deeply and negatively affected by the current financial turmoil. As members of their communities, with the economy in the midst of a very deep, prolonged recession, banks are feeling the effects. It is encouraging to see that several major banking firms have recently announced much better than expected first quarter 2009 earnings. Yet the nation is some ways from getting through this mess, and banks' portfolios reflect this. Nonetheless, the strong position of banks going into this recession is helping them get through it.

Unfortunately, the global financial turmoil, caused primarily by less regulated or unregulated entities like mortgage brokers and by Wall Street firms, has been a major factor in this downturn. There is broad agreement that restructuring of financial regulators is needed to prevent such problems from ever again escalating to current levels.

Before considering the longer-term issues of regulatory restructuring, we note several issues that must be dealt with in the near term. As the financial markets come back – and we note recent signs of renewed life in the markets – it is time to prepare for turning off the federal resuscitation machine. Several programs must be wound down so that the private markets can resume:

- Treasury's guarantee of $50 billion in over 800 money market mutual funds ends this September 19.
- The FDIC and NCUA insurance funds need to be rebuilt. These agencies need to balance their needs for higher premiums against the need to keep funds in local institutions to support lending and economic recovery.
- Unless Congress acts, the general level of FDIC deposit insurance will drop back down from $250,000 to $100,000. ABA supports making the $250,000 level permanent.
- When the FDIC Temporary Liquidity Guarantee Program terminates at year-end, billions of dollars in non-interest-bearing deposit accounts over the insurance limit will become uninsured, and banks and banking firms will no longer issue FDIC-guaranteed debt ($336.2 billion outstanding at the end of March).

- Banks will return the capital investments that they accepted under the Capital Purchase Program of Treasury's Troubled Asset Relief Program, as some have done already.
- The Federal Reserve System balance sheet grew to over $2 trillion in April. There are concerns about the potential exposure to U.S. taxpayers, as well as how the Federal Reserve will ultimately unwind its involvement with all the temporary "facilities," some of which end in October.
- Fannie Mae and Freddie Mac must emerge from federal conservatorship. These agencies are important to homeownership and the banks that make the mortgage loans. Their role in providing a secondary mortgage market needs to be clarified within the broader context of the new regulatory structure.
- Federal home mortgage modification programs should wind down.

Turning to longer-term issues, we believe that any review of the regulatory system should begin with recognition that banks have been and continue to be the primary institutions for saving, lending, and financing economic growth in our nation's communities. Banks are also the leading players in the payments system and the only institutions that participate at every stage of the payments system. Held to high standards of financial strength and integrity of operations, banks are well-poised to be engines of economic recovery and continued economic growth and development.

Bank customers include people and families from all walks of life and involve businesses of all sizes. The innovation and the diversity of the banking industry enable us to meet changing customer needs and interests. Through these efforts in recent decades more people have gained access to a wider array of banking products – and at lower costs – than ever before, and better than anywhere else in the world.

We support a regulatory program that fosters a climate in which we can build on these accomplishments and continue our progress in providing more and better services to more people and businesses at lower costs. With that in mind, we offer the following observations about ways in which changes to the current system could achieve these objectives.

The central objective of regulatory reform efforts should be to enhance banks' ability to meet the needs of their customers with the construct of safety and soundness. It must provide appropriate consumer protections. It needs to promote competition. And it must also foster innovation and facilitate banks' ability to meet changing customer needs. These facets, while distinct, are wholly compatible. A financial institution will best be able to achieve its business objectives by responsibly managing its risks; by providing a full range of products and services to all customers who can responsibly manage their risks; and by competing against others based on price, product quality, reputation, and other customer interests, not by undermining standards of integrity. We believe it is incumbent upon policy makers to create the legal framework that supports these goals.

Any regulatory reform effort must focus on solving the problems that caused the current market turmoil. This necessarily entails identifying what those problems are so that responses can be tailored accordingly. A business model that combines activities that are financial in nature and thereby draws from a diversified revenue mix has shown to be a solution to, and not a part of, the current problems. Thus reform efforts should facilitate banks and other financial institutions offering a broad range of financial products and services. Conversely, reform efforts should be careful not merely to impose new regulations on the banking sector, which did not cause the crisis and which continues to provide credit; rather it should remove unnecessary regulations that impede sound lending and efficient operations.

The current system of bank regulation and oversight has many advantages, and we believe any reform efforts should build on those advantages. As the recent rush by non-bank actors to obtain bank charters has demonstrated, bank regulation and supervision has proven to be the most durable method to minimize risks to safety and soundness. Moreover, it provides a useful check against any one regulator neglecting its duties, becoming too calcified for an ever-changing financial marketplace, growing overly bureaucratic and ineffective, or otherwise imposing regulatory conditions inconsistent with the ability of financial firms to serve their customers. Thus, the ABA supports the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, and the Office of Thrift Supervision with regard to their diverse supervision and oversight responsibilities within the U.S. banking system.

Just as there is a benefit in having multiple federal regulators, so too is there a benefit in having a dual banking system. States have for years operated as incubators for new products and services, such as NOW accounts and adjustable rate mortgages. The dual banking system has proven vital to the continued evolution of the U.S. banking. Close coordination between federal bank regulators and state banking commissioners within the FFIEC as well as during joint bank examinations is a dynamic element of the dual banking system, resulting in a system of complementary supervision.

Recent economic turmoil has drawn attention to the need for a regulator with explicit jurisdiction to manage systemic risk. The primary responsibility of systemic risk regulation should be protecting the economy from major shocks and working with bank supervisors to avoid pro-cyclical directives within the supervisory process. The systemic risk regulator would gather information, monitor exposures throughout the system and take action in concert with domestic and international supervisors to minimize risks to the economy. For maximum effectiveness and ease of implementation, systemic risk regulation should rely on existing regulatory structures and restrict its oversight to a limited number of major market participants, both bank and non-bank.

There clearly is a need for better supervision and regulation of many non-bank actors, such as mortgage banks and brokers that are not affiliated with an insured depository institution. Consumer confidence in the financial sector as a whole suffers when non-bank actors offer bank-like services while operating under substandard or non-existent guidelines for safety and soundness. Lesser-regulated companies and individuals participating in bank-like activities or offering bank-like products and services should be subject to bank-like regulation and capital requirements. Regulatory reform should tackle these issues and bring appropriate oversight to inadequately or ineffectively regulated financial products and services.

This should be done within the context of agencies that have the authority and responsibility to supervise all aspects of an institution's activities. Safety and soundness issues and consumer protection are closely linked for banks and should be supervised as such. Treating consumers unfairly is inconsistent with safe and sound operations; so, too, is attempting to insulate consumers from any risk. Well-run institutions keep both facets in mind, and their regulators should as well. This argues in favor of continuing to place responsibility for both consumer protection and safety and soundness with the banking agencies.

It also should be done in a manner that preserves the independence of the Federal Reserve Board and keeps the Board's primary focus on the conduct of monetary policy. Any expansion of the Board's authority to serve as the systemic risk regulator should be made only if such authority would not create conflicts of interest for the Board or otherwise compromise its ability to carry out its responsibilities for monetary policy.

Any regulatory restructuring effort must recognize the benefits of charter choice. A robust banking sector requires participants of all sizes and business models, including community banks, development banks, and niche-focused financial institutions as well as regional, national, and international banks. Federal and state bank charter alternatives, a broad range of business models, as well as choice of ownership structure (encompassing S corporations, limited liability corporations, mutual ownership, and other forms of publicly-traded and privately-held banks) promotes responsiveness to changing customer needs, consumer preferences, and economic conditions. Only a diverse, well-regulated banking system can bring sustainable increases in homeownership and community development that are essential to economic recovery.

This diversity is not well-served by a system that treats any financial institution as if it were too big or too complex to fail. Such a policy can have serious competitive consequences for the banking industry as a whole. Clear actions strengthening the competitive position of all banks are needed to address and ameliorate the negative effect on the majority of financial institutions when a select few are designated as too big to fail. Moreover, financial regulators should develop a program to identify, monitor, and respond effectively to market developments arising to the perception of an institution as too big or too complex to fail – particularly in times of financial stress. The *ad hoc* approach used in the resolution of Lehman Brothers and Bear Sterns is inadequate. Specific authorities and programs must be developed to manage the orderly transition or resolution of any systemically significant financial institution, bank or non-bank.

Any reform effort also must address issues in our accounting rules that create a pro-cyclical downward drag on the financial sector and the economy as a whole. Accounting should be a reflection of economic reality, not a driver. Reforms to accounting standards should make the standard setting process accountable to the market and implement standards that consider the real-world effects of the rules. Rules governing loan-loss reserves and fair value accounting should minimize pro-cyclical effects that reinforce economic highs and lows. A reformed accounting system would recognize that functioning accounting rules are essential to minimizing systemic risk and fostering economic growth.

In Washington, discussions of regulatory restructuring are focusing on three needs: (1) for a systemic regulator; (2) for a pre-established method for orderly resolution of a systemically significant non-bank financial firm; and (3) to address gaps in our regulatory system. Bankers agree that these three areas should be the priorities to prevent a recurrence of the current problems. ABA's priorities for change are as follows:

- Establish a regulatory structure that provides a mechanism to oversee and address systemic risks. Included under this authority is the ability to mitigate risk-taking from systemically important institutions, authority over how accounting rules are developed and applied, and protections to maintain the integrity of the payments system.
- Establish a method to handle the failure of non-bank institutions that threaten systemic risk.
- Close the gaps in regulation. This might include the regulation of hedge funds, credit default swaps, and particularly non-bank mortgage brokers.

I. Establish a Regulatory Structure that Provides a Mechanism to Oversee and Address Systemic Risks

ABA supports the creation of a systemic regulator. There are various proposals as to who should be the systemic regulator. It makes sense to look for the answer within the parameters of the current regulatory system. Most of the focus has been on giving responsibility to the Federal Reserve, either by giving the authority to this agency directly or by creating an oversight committee chaired by the Federal Reserve. ABA sees the merits of this approach, but is concerned about what it may mean for the independence of the Federal Reserve. We strongly believe that Federal Reserve independence in setting monetary policy is of utmost importance. Moreover, ABA believes that systemic regulation cannot be effective if accounting policy and the payments system are not part of the equation. We should not run the risk of a systemic implosion instigated by gaps in payment system regulation.

A. There is a need for a regulator with explicit systemic risk responsibility.

A systemic risk regulator would strengthen the financial infrastructure. As Chairman Bernanke noted: "[I]t would help make the financial system as a whole better able to withstand future shocks, but also to mitigate moral hazard and the problems of too big to fail by reducing the range of circumstances in which systemic stability concerns might prompt government intervention."[1] ABA believes the following principles should apply to any systemic risk regulator:

- Systemic risk oversight should utilize existing regulatory structures to the maximum extent possible and involve a limited number of large market participants, both bank and non-bank.
- The primary responsibility of the systemic risk regulator should be to protect the economy from major shocks. The systemic risk regulator should pursue this objective by gathering information, monitoring exposures throughout the system, and taking action in coordination with other domestic and international supervisors to reduce the risk of shocks to the economy.
- The systemic risk regulator should work with supervisors to avoid pro-cyclical reactions and directives in the supervisory process.
- There should not be a new consumer regulator for financial institutions. Safety and soundness implications, financial risk, consumer protection, and other relevant issues need to be considered together by the regulator of each institution.

It is clear we need a systemic regulator that looks across the economy and identifies problems. To fulfill that role, the systemic regulator would need broad access to information. It may well make sense to have that same regulator have necessary powers, alone or in conjunction with the Treasury, and a set of tools to address major systemic problems. (Although based on the precedents set over the past few months, it is clear that those tools are already very broad.)

At this point, there seems to be a strong feeling that the Federal Reserve should take on this role in a more robust, explicit fashion. While the Federal Reserve has been generally thought to be looking over the economy, we are concerned, however, that any expansion of the role of the Federal Reserve could interfere with the independence required when setting monetary policy. One of the great

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[1] Ben S. Bernanke, "Financial Reform to Address Systemic Risk," speech at the Council on Foreign Relations, Washington, D.C., March 10, 2009 (www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm).

strengths of our economic infrastructure has been our independent Federal Reserve. The long term impact must be carefully considered if the role of the Federal Reserve is changed.

Thus, ABA offers these guiding principles:

- An independent central bank is essential.
- The Federal Reserve's primary focus should be the conduct of monetary policy.

ABA believes that the FDIC should not take on primary responsibility as the systemic risk authority, although it may serve a role on a systemic risk board; nor should it be responsible for resolutions of failing non-banking firms.

The core function of the FDIC, protection of guaranteed deposits, is absolutely critical to the stability of the overall financial system. Banks are the foundation of the financial system, as they are the key transmission vehicle for accepting deposits and converting these funds into credit. Especially in periods of turmoil, the public looks to the safety of the banks to safeguard funds; and banks are normally the primary source for financing recovery. First and foremost, the FDIC needs to focus its mission on safeguarding this mechanism by protecting guarantee deposits and assuring public confidence that it is fully prepared to fulfill this mission.

If the FDIC takes on additional roles, this can endanger its focus on its core mission. If the additional roles involve exposures to risks other than protection of depositors, losses could develop that undermine the financial stability of the FDIC, and therefore its ability to perform is primary function. Even if the new risk exposure is not attributable to the Deposit Insurance Fund, the risk of public confusion and concern for their deposits would be great.

Non-bank financial institutions have a number of complex functions with which the FDIC has no familiarity, such as hedge funds and insurance. Should the FDIC be called on to resolve such an institution, it has no experience and is not equipped to address these kinds of activities. While it could develop such expertise over time, the time and effort required would be considerable and would take energy and resources away from its primary mission. Even worse, the FDIC would be tainted by the difficulties of new and different institutions facing insurmountable obstacles. The public cannot fail to make this connection, at which point it would only be natural to question the safety of insured deposits.

B. To be effective, the systemic risk regulator must have some authority over the development and implementation of accounting rules.

Accounting standards are not only measurements designed to ensure accurate financial reporting, but they also have an increasingly profound impact on the financial system – so profound that they must now be part of any systemic risk calculation. No systemic risk regulator can do its job if it cannot have some input into accounting standards – standards that have the potential to undermine any action taken by a systemic regulator. Thus, a new system for the establishment of accounting rules – one that considers the real-world effects of accounting rules – needs to be created in recognition of the critical importance of accounting rules to systemic risk and economic activity.

For several years, long before the current downturn, ABA argued that mark-to-market was pro-cyclical and should not be the model used for financial institutions as required by the Financial

Accounting Standards Board (FASB). Even now, the FASB's stated goal is to continue to expand the use of mark to market accounting for all financial instruments. For months, we have specifically asked FASB to address the problem of marking assets to markets that were dysfunctional.

Fair value accounting (mark to market accounting, or MTM) did not cause the financial crisis, although it has exacerbated it. While progress has recently been made in this regard, additional changes are needed to other than temporary impairment (OTTI), estimating fair value in illiquid markets, and MTM for available for sale securities.

MTM has been extremely controversial for many years. Under MTM, certain assets and liabilities are recorded in financial statements at their market values. When the market swings, so do financial statements – often ignoring the underlying economics. All securities that have "other than temporary impairment" (OTTI) must be marked to market, whether the security is available for sale or being held to maturity. This MTM adjustment for OTTI has historically been recorded directly in earnings.

The current market environment has demonstrated the pro-cyclicality and other flaws relating to mark to market accounting. Recording OTTI that is based on credit impairment is non-controversial in the banking industry; banking institutions fully understand and support the need to record such impairment. However, there is much controversy with recording losses that are based on the market's perception of value (MTM), which often results in recognizing losses that exceed credit losses or, even worse, recording losses for instruments that have experienced no credit problems and are fully performing in accordance with their terms. The erosion of earnings and capital due to a market's perception of losses or due to a lack of liquidity that drives values lower is misleading to investors and other users of financial statements.

In today's illiquid market, the results of improper OTTI rules can be severe: capital is artificially eroded despite solid fundamental credit performance, and the lending capability of a bank is needlessly reduced. This furthers the pro-cyclical nature of MTM: reduced lending slows economic activity, putting mortgage borrowers at risk, and further pressuring mortgage security prices. The cycle builds on itself. The misleading information from MTM is contributing to the uncertainty in the markets and the freezing of investment. Even in good times, this pro-cyclical effect introduces significant volatility, and therefore, uncertainty to the financial information. Recommendations by the Group of 30, Chairman Bernanke, and others call for a review of mark to market accounting in light of its inherent pro-cyclical structure.

Thus, ABA sets forth the following principles to guide the development of a new system:

- The setting of accounting standards needs to be strengthened and expanded to include oversight from the regulators responsible for systemic risk.
- Accounting should be a reflection of economic reality, not a driver.
- Accounting rules, such as loan-loss reserves and fair value accounting, should minimize pro-cyclical effects that reinforce booms and busts.
- Clearer guidance is urgently needed on the use of judgment and alternative methods, such as estimating discounted cash flows when determining fair value in cases where asset markets are not functioning and for recording impairment based on expectations of loss.

In creating a new oversight structure for accounting, independence from outside influence should be an important component, as should the critical role in the capital markets of ensuring that accounting standards result in financial reporting that is credible and transparent. But accounting policy can no longer be divorced from its impact; the results on the economy and on the financial system must be considered.

We are very much in agreement with the recommendations of Group of 30, headed by Paul Volcker and Jacob Frenkel on fair value accounting in its *Financial Reform: A Framework for Financial Stability.* That report stated: "The tension between the business purpose served by regulated financial institutions that intermediate credit and liquidity risk and the interests of investors and creditors should be resolved by development of principles-based standards that better reflect the business model of these institutions…." The Group of 30 suggests that accounting standards be reviewed:

- to develop "more realistic guidelines for dealing with less-liquid instruments and distressed markets";
- by "prudential regulators to ensure application in a fashion consistent with safe and sound operation of [financial] institutions"; and
- to be more flexible "in regard to the prudential need for regulated institutions to maintain adequate credit-loss reserves."

Thus, ABA recommends the creation of a board that could stand in place of the functions currently served by the SEC.

C. Uniform standards are needed to maintain the reliability of the payments system.

An important part of the conduct of monetary policy is the reliability of the payments system, including the efficiency, security, and integrity of the payments system. Therefore, ABA offers these three principles:

- The Federal Reserve should have the duty to set the standards for the reliability of the payments system, and have a leading role in the oversight of the efficiency, integrity, and security thereof.
- Reforms of the payments system must recognize that merchants and merchant payment processors have been the source of the largest number of abuses and lost customer information. All parts of the payments system must be responsible for its reliability.
- Ensuring the integrity of the payments system against financial crime and abuse should be an integral part of the supervisory structure that oversees system reliability.

Banks have long been the primary players in the payments system ensuring safe, secure, and efficient funds transfers for consumers and businesses. Banks are subject to a well-defined regulatory structure and are examined to ensure compliance with the standards. Unfortunately, the current regulatory scheme does not apply comparable standards for non-banks that participate in the payments system. This is a significant gap that needs to be filled.

In recent years, non-banks have begun offering "non-traditional" payment services in greater numbers. Internet technological advances combined with the increase in consumer access to the Internet have contributed to growth in these alternative payment options. These activities introduce new risks to the system. Another key difference between banks and non-banks in the payments system is the level of protection granted to consumers in case of a failure to perform. It is important to know the level of capital held by a payment provider where funds are held, and what the effect of a failure would be on customers using the service. This information is not always as apparent as it might be.

The non-banks are not subject to the same standards of performance and financial soundness as banks, nor are they subject to regular examinations to ensure the reliability of their payments operations. In other words, this is yet another gap in our regulatory structure, and one that is growing. This imbalance in standards becomes a competitive problem when customers do not recognize the difference between banks and non-banks when seeking payment services.

In addition, the current standard designed to provide security to the retail payment system, the Payment Card Industry Data Security Standard, compels merchants and merchant payment processors to implement important information security controls, yet tends to be checklist and point-in-time driven, as opposed to the risk-based approach to information security required of banks pursuant to the Gramm-Leach-Bliley Act.[2] Through the Bank Service Company Act, federal bank regulatory agencies can examine larger core payment processors and other technology service providers for GLB compliance.[3] We would encourage the Federal Reserve to use this power more aggressively going forward, and examine an increased number of payment processors and other technology providers.

In order to ensure that consumers are protected from financial, reputational, and systemic risk, all banks and non-bank entities providing significant payment services should be subject to similar standards. This is particularly important for the operation of the payments system, where uninterrupted flow of funds is expected and relied upon by customers. Thus, ABA believes that the Federal Reserve should develop standards for reliability of the payments system that would apply to all payments services providers, comparable to the standards that today apply to payments services provided by banks. The Federal Reserve should review its own authority to supervise non-bank service providers in the payments system and should request from Congress those legislative changes that may be needed to clarify the authority of the Federal Reserve to apply comparable standards for all payments system providers. We support the statement made by Chairman Bernanke: "Given how important robust payment and settlement systems are to financial stability, a good case can be made for granting the Federal Reserve explicit oversight authority for systemically important payment and settlement systems."[4]

II. Establish a Method to Handle the Failure of Non-bank Institutions that Threaten Systemic Risk

We fully agree with Chairman Bernanke when he said: "[T]he United States also needs improved tools to allow the orderly resolution of a systemically important nonbank financial firm, including a mechanism to cover the costs of the resolution."[5] Recent government actions have clearly demonstrated a policy to treat certain financial institutions as if they were too big or too complex to fail. Such a policy can have serious competitive consequences for the banking industry as a whole.

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[2] 16 CFR 314.
[3] 12 USC 1861-1867(c).
[4] *Ben S. Bernanke, "Financial Reform to Address Systemic Risk," speech at the Council on Foreign Relations, Washington, D.C., March 10, 2009 (www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm).*
[5] *Ibid.*

Without accepting the inevitability of such a policy, clear actions must be taken to address and ameliorate negative consequences of such a policy, including efforts to strengthen the competitive position of banks of all sizes.

The current *ad hoc* approach, used with Bear Stearns and Lehman Brothers, has led to significant unintended consequences and needs to be replaced with a concrete, well-understood method of resolution. There is such a system for banks, and that system can serve as a model. However, the system for banks is based in an elaborate system of bank regulation and the bank safety net. The system for non-banks should not extend the safety net, but rather should provide a mechanism for failure designed to limit contagion of problems in the financial system.

These concerns should inform the debate about the appropriate actor to resolve systemically significant non-banks. While some suggest that the FDIC should have broader authority to resolve all systemically significant financial institutions, we respectfully submit that the FDIC's mission must not be compromised by a dilution of resources or focus. Confidence in federal deposit insurance is essential to the health of the banking system. Our system of deposit insurance is paid for by insured depository institutions and, until very recently, has been focused exclusively on insured depository institutions. The costs of resolving non-banks must not be imposed on insured depository institutions; rather, institutions subject to the new resolution authority should pay the costs of its execution. Given that these costs are likely to be very high, it is doubtful that institutions that would be subject to the new resolution authority would be able to pay premiums large enough to fully fund the resolution costs. In that case, the FDIC would need to turn to the taxpayer and, thereby, jeopardize confidence in the banking industry as a whole.

Even if systemically significant non-banks could fully fund the new resolution authority, one agency serving as both deposit insurer and the agency that resolves non-depository institutions creates the risk of a conflict of interest, as Comptroller John Dugan recently observed in testimony before Congress.[6] The FDIC must remain focused on preserving the insurance fund and, by extension, the public's confidence in our nation's depository institutions. Any competing role that distracts from that focus must be avoided.

Thus, ABA offers several principles to guide this discussion:

- Financial regulators should develop a program to watch for, monitor, and respond effectively to market developments relating to perceptions of institutions being too big or too complex to fail—particularly in times of financial stress.
- Specific authorities and programs must be developed that allow for the orderly transition of the operations of any systemically significant financial institution.

The creation of a systemic regulator and of a mechanism for addressing the resolution of entities, of course, raises the important and difficult question of what institutions should be considered systemically important, or in other terms, too-big-to-fail. The theory of too-big-to-fail (TBTF) has in this crisis been expanded to include institutions that are too intertwined with other important institutions to be allowed to fail. We agree with Chairman Bernanke when he said that the "clear

[6] John C. Dugan, Comptroller of the Currency, testimony before the Senate Committee on Banking, Housing, and Urban Affairs, March 19, 2009 (www.occ.gov/ftp/release/2009-24b.pdf).

guidelines must define which firms could be subject to the alternative [resolution] regime and the process for invoking that regime."[7]

ABA has always sought the tightest possible language for the systemic risk exception in order to limit the TBTF concept as much as possible. We did this for two reasons, reasons that still apply today: first, TBTF presents the classic moral hazard problem – it can encourage excess risk-taking by an entity because the government will not allow it to fail; second, TBTF presents profound competitive fairness issues – TBTF entities will have an advantage – particularly in funding, through deposits and otherwise – over institutions that are ***not*** too big to fail.

Our country has now stretched the systemic risk exception beyond what could have been anticipated when it was created. In fact, we have gone well beyond its application to banks, as we have made non-banks TBTF. Ideally, we would go back and strictly limit its application, but that may not be possible. Therefore, we need to adopt a series of policies that will address the moral hazard and unfair competition issues while protecting our financial system and the taxpayers. This may be the most difficult question Congress will face as it reforms our financial system.

For one thing, this cannot be done in isolation from what is being done in other countries. Systemic risk clearly does not stop at the border. In addition, the ability to compete internationally will be a continuing factor in designing and evolving our regulatory system. Our largest financial institutions compete around the world, and many foreign institutions have a large presence in the United States.

This is also a huge issue for the thousands of U.S. banks that will not be considered too big to fail. As ABA has noted on many occasions, these are institutions that never made a toxic subprime loan, are well capitalized, and are lending. Yet we have been deeply and negatively affected by this crisis – a crisis caused primarily by less regulated or unregulated entities like mortgage brokers and by Wall Street firms. We have seen the name "bank" sullied as it is used very broadly; we have seen our local economies hurt, and sometimes devastated, which has led to loan losses; and we have seen deposit insurance premiums drastically increased to pay for the excessive risk-taking of institutions that have failed. At the same time, there is a clear unfairness in that many depositors believe their funds, above the insurance limit, are safer in a TBTF institution than other banks. And, in fact, this notion is reinforced when large uninsured depositors lose money – take a "haircut" – when the FDIC closes some not-too-big-to fail banks.

There are many difficult questions. How will a determination be made that an institution is systemically important? When will it be made? What extra regulations will apply? Will additional capital and risk management requirements be imposed? How will management issues be addressed? Some have argued that the largest, most complex institutions are too big to manage. Which activities will be put off-limits and which will require special treatment, such as extra capital to protect against losses? How do we avoid another AIG situation, where, it is widely agreed, what amounted to a risky hedge fund was attached to a strong insurance company and brought the whole entity down? And, importantly, how do we make sure we maintain the highly diversified financial system that is unique to the United States?

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[7] John C. Dugan, Comptroller of the Currency, testimony before the Senate Committee on Banking, Housing, and Urban Affairs, March 19, 2009 (www.occ.gov/ftp/release/2009-24b.pdf).

III. Close the Gaps in Regulation

A major cause of our current problems is the regulatory gaps that allowed some entities to completely escape effective regulation. It is now apparent to everyone that a critical gap occurred with respect to the lack of regulation of independent mortgage brokers. Questions are also being raised with respect to credit derivatives, hedge funds, and others.

Given the causes of the current problem, there has been a logical move to begin applying more bank-like regulation to the less-regulated and un-regulated parts of the financial system. For example, when certain securities firms were granted access to the discount window, they were quickly subjected to bank-like leverage and capital requirements. Moreover, as regulatory change points more toward the banking model, so too has the marketplace. The biggest example, of course, is the movement of Goldman Sachs and Morgan Stanley to Federal Reserve holding company regulation.

As these gaps are being addressed, Congress should be careful not to impose new, unnecessary regulations on the traditional banking sector, which was not the source of the crisis and continues to provide credit. Thousands of community banks, in communities across the country, are scared that their already-crushing regulatory burdens will be increased dramatically by regulations aimed primarily at their less-regulated or unregulated competitors. Even worse, the new regulations will be lightly applied to non-banks while they will be rigorously applied – down to the last comma – to banks.

Congress has worked hard in recent years to temper the impact of regulation on banks. It has passed bills to remove unnecessary regulation, and you have made existing regulation more efficient and less costly. As legislators contemplate major changes in regulation – and change is needed – ABA would urge them to ask this simple question: how will this change impact those thousands of banks that make the loans needed to get our economy moving again?

There are so many issues related to closing the regulatory gaps. Some important issues to ABA are summarized in the following principles:

- The current system of bank regulators has many advantages. These advantages should be preserved as the system is enhanced to address systemic risk and non-bank resolutions.
  - Regulatory restructuring should incorporate systemic checks and balances among equals and a federalist system that respects the jurisdictions of state and federal powers. These are essential elements of U.S. law and governance.
  - We support the roles of the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), Federal Reserve, the Office of Thrift Supervision (OTS) and the state banking commissioners with regard to their diverse responsibilities and charters within the U.S. banking system.
  - Bank regulators should focus on bank supervision. They should not be in the business of running banks or managing bank assets and liabilities.

- The dual banking system is essential to promote an efficient and competitive banking sector.
  - The role of the dual banking system as incubator for advancements in products and services, such as NOW and checking accounts, is vital to the continued evolution of the U.S. banking sector.

    - Close coordination between federal bank regulators and state banking commissioners within Federal Financial Institutions Examination Council (FFIEC) as well as during joint bank examinations is an essential and dynamic element of the dual banking system.

- Charter choice and choice of ownership structure are essential to a dynamic, innovative banking sector that responds to changing consumer needs, customer preferences, and economic conditions.
    - Choice of charter and form of ownership should be fully protected.
    - ABA strongly opposes charter consolidation. Unlike the flexibility and business options available under charter choice, a consolidated universal charter would be unlikely to serve evolving customer needs or encourage market innovation.
    - Diversity of ownership, including S Corporations, limited liability corporations, mutual ownership, and other forms of privately held and publicly traded banks, should be strengthened.
- Diversity of business models is a distinctive feature of U.S. banking that should be fostered.
    - Full and fair competition within a robust banking sector requires a diversity of participants of all sizes and business models with comparable banking powers and appropriate oversight.
    - Community banks, development banks, and niche-focused financial institutions are vital components of the financial services sector.
    - A housing-focused banking system based on time-tested underwriting practices and disciplined borrower qualification is essential to sustained homeownership and community development.
- An optional federal insurance charter should be created.
- Similar activities should be subject to similar regulation and capital requirements. These regulations and requirements should minimize pro-cyclical effects.
    - Consumer confidence in the financial sector as a whole suffers when non-bank actors offer bank-like services while operating under substandard guidelines for safety and soundness.
    - Credit unions that act like banks should be required to convert to a bank charter.
    - Capital requirements should be universally and consistently applied to all institutions offering bank-like products and services.
    - Credit default swaps and other products that pose potential systemic risk should be subject to supervision and oversight that increase transparency, without unduly limiting innovation and the operation of markets.
    - Where possible, regulations should avoid adding burdens during times of stress. Thus, for instance, deposit insurance premium rates need to reflect a balance between the need to strengthen the fund and the need of banks to have funds available to meet the credit needs of their communities in the midst of an economic downturn.
- The FDIC should remain focused on its primary mission of ensuring the safety of insured deposits.
    - The FDIC plays a crucial role in maintaining the stability and public confidence in the nation's financial system by insuring deposits, and in conducting activities directly related to that mission, including examination and supervision of financial

institutions as well as managing receiverships and assets of failed banking institutions so as to minimize the costs to FDIC resources.
    - The FDIC should not take on primary responsibility as the systemic risk authority, although it may serve a role on a systemic risk board; nor should it be responsible for resolutions of failing non-banking firms.
- To coordinate anti-money laundering oversight and compliance, a Bank Secrecy Act "gatekeeper," independent from law enforcement and with a nexus to the payments system, should be incorporated into the financial regulatory structure.

IV. Conclusion

The financial turmoil over the last year, and particularly the protection provided to institutions deemed to be "systemically important," require a system that will more efficiently and effectively prevent such problems from arising in the first place and a procedure to deal with any problems that do arise. Clearly, it is time to make changes in the financial regulatory structure. We hope that the principles laid out here will help guide the discussion.