

Testimony of

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Chairman Lieberman, Ranking Member Collins and Members of the Committee, thank you for inviting me to appear before you today on financial services regulatory matters. These are important and timely issues to discuss, especially from the global perspective. As the United States begins to evaluate its financial regulatory framework, it is vital that it incorporate lessons and experience from other countries' reform efforts.

I currently serve as a Managing Director of the Promontory Financial Group, LLC, a global financial services consulting firm founded by Eugene Ludwig, a former Comptroller of Currency in the Clinton Administration. I am particularly pleased to be joined here by Mr. Jeffrey Carmichael, who is also part of the Promontory firm, and leads Promontory's Australasia office, based in Singapore. I recently finished a three-year stint at the U.S. Department of Treasury where I was honored to serve both Secretaries Snow and Paulson. As the Assistant Secretary of Treasury for financial institutions, I advised former Secretary Paulson on Treasury's responses to the current financial crisis, including many aspects of the Troubled Asset Relief Program ("TARP") and related financial stability efforts. In addition, I am particularly proud to have led the team that researched and wrote Treasury's *"Blueprint for a Modernized Financial Regulatory Structure"* ("Blueprint") which was published in March 2008. Many of the issues that we evaluated in the writing of the Blueprint are before the Congress and the focus of this hearing.

I. Introduction

Financial institutions play an essential role in the U.S. economy by providing consumers and businesses a means to save for the future, to protect and hedge against risks, and to access funding for consumption or organize capital for new investment opportunities. A number of different types of financial institutions provide financial services in the United States: commercial banks and other insured depository institutions, insurers, companies engaged in securities and futures transactions, finance companies, and specialized companies established by the government. Together, these institutions and the markets in which they act underpin economic activity through the intermediation of funds between providers and users of capital.

This intermediation function is accomplished in a number of ways. Overall, financial institutions serve a vitally important function in the U.S. economy by allowing capital to seek out its most productive uses in an efficient matter. Given the economic significance of the U.S. financial services sector, it is important that we examine the structure of our regulatory framework. This is all the more pressing as the United States begins to emerge from the current financial crisis.

Even before this financial crisis, however, many had recognized that the capital markets and the financial services industry have evolved significantly over the past decade. These developments, while providing benefits to both domestic and global economic growth, have also exposed the financial markets to new challenges. Globalization of the capital markets is a significant development. Foreign economies are maturing into market-based economies, contributing to global economic growth and stability and providing a deep and liquid source of capital outside the United States. There is an emerging consensus that a regulatory framework that combines flexibility and prudence is best suited to respond to financial markets' dynamism and complexity.

The root causes of the current financial markets stress are well documented. Following many years of benign economic conditions and plentiful market liquidity, global investors had become complacent about risks, even in the case of new and increasingly complex financial instruments. There was a dramatic weakening of underwriting standards for U.S. mortgages, especially subprime mortgages, beginning in late 2004 and extending into early 2007. The loosening of credit terms in the subprime market was symptomatic of a much broader erosion of market discipline on the standards and terms of loans to households and businesses.

The confluence of many events led to a significant credit contraction and a dramatic repricing of risk. Sentiment swung hard to risk aversion and there was an erosion of confidence in financial firms across the globe. We are still living through this process right now and we have seen more government intervention in the financial markets than we have seen in decades.

The focus of this hearing today is prospective, however. How can we in the United States do better and what can we learn from our colleagues around the world? The financial crisis has taught us that regulatory structure is not merely an academic issue and that topics like regulatory arbitrage matter and have meaningful repercussions outside of the province of academia. Indeed, if we look for something positive in the aftermath of this crisis it might be that it will give us the courage to make the hard choices and reform our financial regulatory architecture.

We have learned that our regulators and regulations were not well positioned to adapt to the rapid financial innovation driven by rapid capital mobility, deep liquidity, and technology. These conditions led to three major financial developments that were contributors to the crisis: the rapid proliferation of structured financial instruments, the growth of credit markets outside of the traditional regulated framework, and false confidence in internal and external risk management practices and credit ratings agencies. Financial institutions and regulators alike touted the benefits of these innovations as tools to diffuse risk throughout the financial system.

Unfortunately, many did not recognize that the growth of the financial institutions' cross-market activities and integration with the broader economy ensured that turmoil in one part of the financial markets would spread to others, and ultimately to the real economy.

Regulation alone and modernized regulatory architecture could not have prevented all of the problems from these developments. However, a more robust regulatory framework with oversight responsibility for cross-market activities and a focus on systemic risk could have recognized their collective dangers and could have potentially acted preemptively to limit their impact.

II. Brief Discussion of the Current US Regulatory Structure:

Our current regulatory structure no longer reflects the complexity and dynamic nature of today's financial markets.

The current U.S. regulatory framework for financial institutions is based on a structure that developed over many decades. Uniquely among nations, we have a dual banking system that is deeply rooted in our national character and reflects the distaste for centralized economic authority that characterized the earliest years of our republic. The regulatory basis for depository institutions evolved gradually in response to a series of financial crises and other important social, economic, and political events: Congress established the national bank charter in 1863 during the Civil War, the Federal Reserve System in 1913 in response to various episodes of financial instability, and the federal deposit insurance system and specialized insured depository charters (e.g., thrifts and credit unions) during the Great Depression. Changes were made to the regulatory system for insured depository institutions in the intervening years in response to other financial crises (e.g., the thrift crises of the 1980s) or as enhancements (e.g., the Gramm-Leach-Bliley Act of 1999, or "GLB Act"); but, for the most part the underlying structure resembles what existed in the 1930s.

Similarly, the bifurcation between securities and futures regulation was largely established over seventy years ago when the two industries were clearly distinct. In addition to the federal role for financial institution regulation, the tradition of federalism preserved a role for state authorities in certain markets. This is especially true in the insurance market, which states have regulated with limited federal involvement for over 135 years. However, state authority over depository institutions and securities companies has diminished over the years. In some cases there is a cooperative arrangement between federal and state officials, while in other cases tensions remain as to the level of state authority. In contrast, futures are regulated solely at the federal level.

Historically, the regulatory structure for financial institutions has served the United States well. However, the complexity intrinsic to our evolving financial markets and the growing institutionalization of the capital markets and the severity of the current financial crisis is pressuring the U.S. regulatory structure, exposing regulatory gaps as well as redundancies. The U.S. regulatory structure reflects a system, much of it created over seventy years ago, grappling

to keep pace with market evolutions and, facing increasing difficulties, at times, in preventing and anticipating financial crises.

Largely incompatible with these developments is the current system of functional regulation, which maintains separate regulatory agencies across segregated functional lines of financial services, such as banking, insurance, securities, and futures. A functional approach to regulation exhibits several inadequacies, the most significant being the fact that no single regulator possesses all of the information and authority necessary to monitor systemic risk, or the potential that events associated with financial institutions may trigger broad dislocation or a series of defaults that affect the financial system so significantly that the real economy is adversely affected. In addition, the inability of any regulator to take coordinated action throughout the financial system makes it more difficult to address problems related to financial market stability.

Moreover, our system also results in duplication of certain common activities across regulators. While some degree of specialization might be important for the regulation of financial institutions, many aspects of financial regulation and consumer protection regulation have common themes. For example, although key measures of financial health have different terminology in banking and insurance—capital and surplus respectively—they both serve a similar function of ensuring the financial strength and ability of financial institutions to meet their obligations. Similarly, while there are specific differences across institutions, the goal of most consumer protection regulation is to ensure consumers receive adequate information regarding the terms of financial transactions and industry complies with appropriate sales practices. American regulatory inefficiencies, which were once primarily concerns for the competitiveness of the US financial sector, have revealed themselves as major threat to the stability of the US and global economy. We must seize the present opportunity to realize both the objectives.

III. Comparison of Regulatory Models Around the World

As we consider the future construct of our financial regulation, we should first look to the experience of others countries, especially those that have conducted a thoughtful review recently. As global financial markets integrate and accounting standards converge, it is only natural for regulatory practices to follow suit. There are two dominant forms of financial regulatory regimes that should be considered seriously, the consolidated regulator approach and the “Twin Peaks” approach.

Under a single consolidated regulator approach, one regulator responsible for both financial and consumer protection regulation would regulate all financial institutions. The United Kingdom’s consolidation of regulation within the Financial Services Authority exemplifies this approach, although other countries such as Japan have also moved in this direction. The general consolidated regulator approach eliminates the role of the central bank from financial institution regulation, but preserves its role of determining monetary policy and performing some functions related to overall financial market stability.

A key advantage of the consolidated regulator approach is enhanced efficiency from combining common functions undertaken by individual regulators into one entity. A consolidated regulator approach should allow for a better understanding of overall risks to the financial system as one entity would regulate all financial institutions. This last benefit increases in importance as the size and significance of diversified financial conglomerates rises. Finally, a consolidated regulator approach avoids issues associated with overlapping jurisdictions of individual regulators.

While the consolidated regulator approach can deliver a number of benefits, several potential problems also arise. First, housing all regulatory functions related to financial and consumer regulation in one entity may lead to varying degrees of focus on these key functions. Second, a consolidated regulator approach to financial oversight might also lead to less market discipline as the same regulator would regulate all financial institutions, whether or not they have explicit government guarantees. This would seem to be particularly important in the United States where a number of financial institutions have access to explicit government guarantees of varying degrees. Third, since regulatory reform must consider the role of the central bank, the consolidated regulatory approach must maintain some degree of close coordination with the central bank if the central bank is going to be ultimately responsible for some aspect of market stability. This is especially important as the Turner Report, which analyzes and reviews the U.K. regulatory system, requires a shifting of focus to systemically important banks, validation of risk models, more information disclosure on key risks, and the establishment of a resolution authority for large financial institutions.

Finally, the scale of operations necessary to establish a single consolidated regulator in the United States could make the model more difficult to implement in comparison to other jurisdictions.

Another approach, adopted mostly notably by Australia and the Netherlands, is the “Twin Peaks” model that emphasizes regulation by objectives. One regulatory body is responsible for prudential regulation of relevant financial institutions and a separate and distinct agency is responsible for business conduct and consumer protection. The primary advantage of this model is that it maximizes regulatory focus by concentrating responsibility for correcting a single form of market failure — one agency, one objective. This consolidation reduces regulatory gaps, turf wars among regulators and the opportunities for regulatory arbitrage by financial institutions, while unlocking natural synergies among regulatory agencies. Perhaps most importantly, it reflects the financial markets’ extraordinary integration and complexity. This structure does pose a key problem in that that effective lines of communication between the “peaks” is vital to success. Effective communication among regulators is important for coordinating examinations and other activities impacting the operations of financial institutions.

IV. Idea and Proposals Under Consideration:

While there are several ideas and proposals for the reform of the financial regulatory system in circulation, I would like to focus on three ideas that were described in the Treasury's March 2008 Blueprint, Secretary Geithner's Testimony to the House Financial Services Committee on March 26, 2009, and FDIC Chairman Bair's testimony to the Senate Committee on Banking, Housing & Urban Affairs on May 6, 2009. Each of these proposals calls for the establishment of systemic risk regulation.

The March 2008 Blueprint proposes that the US adopt an objectives-based regulatory framework with three objectives: market stability regulation, prudential financial regulation to address issues of limited market discipline and business conduct regulation. Prudential financial regulation housed within one regulatory body can focus on the common elements of risk management across financial institutions, as the current crisis revealed the devastating impact of their cross-market exposure. Regulators focused on specific objectives can be more effective at enforcing market discipline by their targeting of financial institutions for which prudential regulation is most appropriate.

The Blueprint lays out an optimal structure consisting of three distinct regulators focused exclusively on financial institutions: a market stability regulator, a prudential financial regulator and a business conduct regulator.

In his testimony to the House Financial Services Committee, Secretary Geithner called for the creation of single regulatory entity with responsibility for systemically important institutions, critical payment and settlement activities. This regulator should impose capital, liquidity, counterparty and credit risk management requirements that are more stringent than other, smaller financial institutions. Secretary Geithner emphasized that these requirements must be designed to dampen, rather than amplify financial cycles. Similar to the Turner Report for the UK, Secretary Geithner recommended that a stronger resolution mechanism for large complex financial institutions, under permanent authority, be a cornerstone of future financial regulation.

FDIC Chairman Sheila Bair addressed the regulatory challenges for financial institutions deemed to "too big to fail" in her recent testimony to the Senate. The failure of one of these institutions poses a significant danger to the economy while their complexity limits effective supervision. The challenge therefore is to create a fail-safe system where if one institution fails, the system can avoid a near domino-like collapse of other financial institutions. Chairman Bair proposed the two consistently mentioned approaches to reduce this likelihood: first, devise a supervisory framework to regulate systemic risk; second, establish comprehensive resolution authority for systemically important financial institutions to make their failure credible and feasible.

V. Conclusions

While there is an emerging consensus among global financial regulators, market participants, and policy makers that systemic risk regulation and resolution authority must be a cornerstone of reformed financial regulation, the exact details of proposals need to be settled. These are very complicated issues that require thoughtful debate and deliberation.

One point, however, is clear — the United States’ regulatory system, in its current form, is incapable of guarding against the risks that brought our financial markets and our economy to the brink of collapse. As we expand our financial regulatory authorities and power, we should guard against natural tendencies of associating “more” regulation with “good” regulation. Innovation, evolution and profitability are critical to retaining the global leadership of the American financial sector. To this end, the future American regulatory framework must be directed toward its proper objectives — to maintain a stable, well-capitalized and responsible financial sector that will supply the credit and allocate capital efficiently to grow our real economy.

Thank you for inviting me here today.