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Establishing a Framework for Systemic Risk Regulation: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs, 111th Cong., July 23, 2009 (Statement of Daniel K. Tarullo, Geo. U. L. Center)

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Hearing: Establishing a Framework for Systemic Risk Regulation

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U.S. Senate Committee on Banking, Housing and Urban Affairs

Thank you, Mr. Chairman, Senator Shelby and members of the committee. My prepared statement sets forth in some detail the positions of the Federal Reserve on a number of the proposals that have been brought before you, so I thought I would use these introductory remarks to offer a few more general points.

First, I think the title you've given this hearing captures the task well, "Establishing a Framework for Systemic Risk Regulation." The task is not to enact one piece of legislation or to establish one over-arching systemic risk regulator and then to move on.

The shortcomings of our regulatory system were too widespread, the failure of risk management at financial firms too pervasive, and the absence of market discipline too apparent to believe that there was a single cause of, much less a single solution for, the financial crisis. We need a broad agenda of basic changes at our regulatory agencies and in financial firms, and a sustained effort to embed market discipline in financial markets.

Second, the too big to fail problem looms large on the agenda. Therein lies the importance of proposals to ensure that systemically important institutions are subject to supervision, to promote capital and other kinds of rules that will apply more stringently as the systemic importance of an institution increases, and to establish a resolution mechanism that makes the prospect of losses for creditors real, even at the largest of financial institutions.

But too big to fail, for all its importance, is not the only problem left unaddressed for too long. The increasingly tightly wound connection between lending and capital markets, including the explosive growth of the shadow banking system, was not dealt with as leverage built up throughout the financial system.

That is why there are also proposals before you pertaining to derivatives, money market funds, ratings agencies, mortgage products, pro-cyclical regulations, and a host of other issues involving every financial regulator.

Third, in keeping with my first point on a broad agenda for change, let me say a few words about the Federal Reserve. Even before my confirmation I had begun conversations with many of you on the question of how to ensure that the shortcomings of the past would be rectified and the right institutional structure for rigorous and efficient regulation put in place, particularly in light of the need for a new emphasis on systemic risk.

This colloquy has continued through the prior hearing your committee conducted and in subsequent conversations that I have had with many of you. My colleagues and I have thought a good deal about this question and are moving forward with a series of changes to achieve these ends.

For example, we're instituting closer coordination and supervision of the largest holding companies, with an emphasis on horizontal reviews that simultaneously examine multiple institutions.

In addition, building on our experience with the SCAP process that drew so successfully upon the analytic and financial capacities of the non-supervisory divisions of the board, we will create a quantitative surveillance program that will use a variety of data sources to identify developing strains and imbalances affecting individual funds and large institutions as a group.

This program will be distinct from the activities of the onsite examiners, so as to provide an independent perspective on the financial condition of the institutions.

Fourth, and finally, I would note that there are many possible ways to organize or to reorganize the financial regulatory structure. Many are plausible, but, as experience around the world suggests, none is perfect. There will be disadvantages as well as advantages to even good ideas.

One criterion, though, that I suggest you keep in mind as you consider various institutional alternatives is the basic principle of accountability. Collective bodies of regulators can serve many useful purposes -- examining latent problems, coordinating a response to new problems, recommending new action to plug regulatory gaps, and scrutinizing proposals for significant regulatory initiatives from all participating agencies.

When it comes to specific regulations, or programs or implementation, though, collective bodies often diffuse responsibility and attenuate the lines of accountability, which I know this committee has paid so much attention to. Achieving an effective mix of collective process and agency responsibility, with an eye towards relevant institutional incentives, will be critical to successful reform.

Thank you very much, Mr. Chairman. I'd be happy to answer any questions.