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President and COO

The Financial Services Forum

before the
Committee on Financial Services
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Chairman Frank, Ranking Member Bachus, subcommittee Chairman Watt and Ranking Member Paul, thank you for the opportunity to participate in today's hearing and to share the Financial Services Forum's views regarding the Federal Reserve and, specifically, the critical importance of supervisory authority to the central bank's effective discharge of its duties as the nation's monetary authority.

As you may know, the Forum is a nonpartisan financial and economic policy organization comprised of the chief executives of 18 of the largest and most diversified financial institutions with business operations in the United States. The purpose of the Forum is to promote policies that enhance savings and investment and that ensure an open, competitive, and sound global financial services marketplace.

Reform and modernization of our nation's framework of financial supervision is critically important. The Forum thanks you, Mr. Chairman, and all the members of the Committee for their tireless work over the past 15 months. To reclaim its position of financial and economic leadership, the United States needs a 21^{st} century supervisory framework that is effective and efficient, ensures institutional safety and soundness and systemic stability, promotes the competitive and innovative capacity of the U.S. capital markets, and protects the interests of depositors, consumers, investors, and policyholders.

In the Forum's view, the essential elements of meaningful reform are enhanced consumer protections including strong national standards, systemic supervision, ending "too-big-to-fail" by establishing the authority and procedural framework for winding down any financial institution in an orderly way, and a strong, effective, and credible central bank — which requires supervisory authority.

On Dec. 11^{th}, this Committee passed a financial reform bill that would preserve and even expand the Federal Reserve's role as a supervisor of financial institutions. On Monday, Senator Dodd, Chairman of the Senate Banking Committee, released a draft bill that would assign supervision of bank and thrift holding companies with assets greater than $50 billion to the Fed. While we are pleased that the Fed retains meaningful supervisory authority in the Senate bill, we also believe that the Fed and the U.S. financial system would benefit from the Fed also having a supervisory dialogue with small- and medium-sized institutions.

As this 15-month debate regarding the modernization our supervisory architecture has unfolded, some policymakers have held the view that the Fed should be stripped of all supervisory powers. In the Forum's view, stripping the Fed would severely undermine the strength, effectiveness, and credibility of the central bank, with very negative implications for monetary policy, the stability of the U.S. financial system and, therefore, the productive capacity of the U.S. economy.
As a means of demonstrating the importance of supervision to monetary policy, I'd like to touch on two notions that are most frequently cited by those who argue that the Fed should not be a supervisor of financial institutions:

- first, that the Fed's supervisory record during the recent financial crisis was one of "utter failure;" and,

- second, that supervisory duties are a burden to the Fed and distract the central bank from its core responsibility as the monetary authority and lender-of-last-resort.

In our respectful view, these notions do not hold up under examination and thus should not drive policymakers' reform deliberations.

The notion that the Federal Reserve is a supervisory failure is refuted by numerous facts. Most of the institutions most frequently referenced in the context of the financial crisis — namely, Bear Sterns, Lehman Brothers, Merrill Lynch, Countrywide, IndyMac, Washington Mutual, AIG, Freddie Mac, and Fannie Mae — were not supervised by the Fed, at either the subsidiary or the holding company level.

The Fed supervises state-chartered banks that are members of the Federal Reserve System and all bank holding companies. Of the more than 5,500 bank holding companies, only two sustained losses during the crisis that threatened their survival. Indeed, three of the largest Fed-supervised bank holding companies served as instruments of stabilization and recovery by absorbing other failing institutions — Wells Fargo absorbed Wachovia; JPMorgan Chase absorbed Bear Stearns and Washington Mutual; and Bank of America absorbed Countrywide and Merrill Lynch.

Since January of 2009, Mr. Chairman, 170 banks have failed in the United States — the highest rate of failure since 1991. 98 of those failures were FDIC-supervised banks, 28 were OCC-supervised banks, 23 were OTS-supervised thrifts, and 21 were Fed-supervised banks. This is not to argue that any particular supervisor is better than the others — all have performed at sub-par levels, and significant improvement is necessary. Yet, while no regulatory agency batted a thousand leading up to the crisis, characterizations of the Federal Reserve as an "utter failure" as a safety and soundness supervisor are simply incorrect.

The argument that supervisory activities overburden or distract the Fed from its duties as the monetary authority is also a notion we do not share. Far from a distraction, supervision is altogether consistent with and supportive of the Fed's critical role as the monetary authority and lender-of-last-resort for the very simple and straightforward reason that financial institutions are the transmission belt of monetary policy.

First-hand knowledge and understanding of the activities, condition, and risk profiles of the financial institutions *through* which it conducts open-market operations — or *to* which it might extend discount window lending — is critical to the Fed's effectiveness as the monetary authority and lender-of-last-resort.

And experience has repeatedly shown that it is in times of turmoil — in the deep recession of 1991, in the difficult months following 9/11, in the darkest days of the most recent crisis, and currently as the economy struggles to find its footing — that such detailed, first-hand knowledge of circumstances within banks becomes especially critical. It must be kept in mind that the banking system is the mechanical gearing that connects the lever of monetary policy to the wheels of economic activity. If that critical gearing is broken or defective, monetary policy changes by the Fed will have little or even none of the intended impact on the broader economy.

In addition, in order for the Federal Reserve to look across financial institutions, and the interactions between them and the markets for emerging risks, as it currently does, it is vital that the Fed have an accurate picture of circumstances within banks. By playing a supervisory role during crises, the Fed has a first-hand view of banks, is a provider of short-term liquidity support, and oversees vital clearing and settlement systems.

When Chairman Bernanke testified before this Committee on February 24th, the question he was asked most frequently was, "What can be done to increase bank lending to small businesses?" Unless the Federal Reserve maintains supervisory authority over a substantial portion of the nation's banking companies, it would have no authority, no leverage, at its disposal to work with banks to ensure that creditworthy businesses have access to the capital and credit they need to expand and create jobs.

On the topic of the Fed's lender-of-last-resort role, Mr. Chairman, I'd like to pause briefly to make an important point. Many are mistakenly of the view that discount window lending by the Fed is either equivalent with, or leads to, bank bail-outs. Such assertions are inaccurate. A bail-out is lending, or injecting capital into, a failing — that is, insolvent — institution. By stark contrast, the Federal Reserve Act explicitly restricts discount window lending to solvent institutions who find themselves temporarily illiquid. Such loans are short-term — usually over night — extended on fully collateralized terms, with the value of the offered collateral steeply discounted. In nearly 100 years of discount window lending, the Federal Reserve has never lost a dime. Such strictly prescribed liquidity lending by the Fed is essential to financial system stability and is, therefore, a perfectly legitimate activity of any central bank.

There are other reasons, Mr. Chairman, to ensure that the Fed remains a supervisor of financial institutions. For example, the Fed has unrivaled institutional experience as a supervisor. It has been a supervisor of financial institutions since its creation by Congress in 1913, has supervised bank holding companies since those entities first became subject to federal supervision in 1956, and was designated by the Gramm-Leach-Bliley Act of 1999 as the "umbrella supervisor" of financial conglomerates that include banking, securities, and insurance entities.

And since the Fall of 2008, a number of major non-bank financial institutions — Goldman Sachs, Morgan Stanley, American Express, and even GMAC — have become bank holding companies and submitted to consolidated oversight by the Fed.

U.S. policymakers should also be mindful of international trends in the wake of the financial crisis. In the United Kingdom, for example, serious consideration is being given to shifting bank supervision back to the Bank of England, which had been stripped of such powers when the Financial Services Authority was created in 2001. It has been acknowledged that the lack of supervisory authority, and the detailed knowledge and information derived from such authority, likely undermined the Bank of England's ability to swiftly and effectively respond to the recent financial crisis.

Similarly, in Germany, the new coalition government announced in October that significant supervisory powers would be shifted to the Bundesbank from the financial market regulator, known as BaFin. And while the Bank of Japan has no statutorily expressed supervisory powers, the Bank examines any organization that has access to its credit facilities.

Mr. Chairman, Americans are justifiably angry about the financial crisis and its impact on the broader economy. The Fed is a convenient target for that anger, given the central role it played in combating the recent financial crisis. But punishing the Fed would be like attacking the fire department for water damage caused while saving the neighborhood from a catastrophic fire.

More fundamentally, the goal of financial reform is a supervisory framework that makes our financial system more stable, flexible, and resilient. Achieving that goal requires a central bank that is strong and independent, and an effective and credible monetary authority — and supervisory power is essential to that important objective.

Again, thank you for the opportunity to appear before the Committee today.