Secretary Timothy F. Geithner
FINAL Written Testimony
House Financial Services Committee
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Chairman Frank, Ranking Member Bachus, members of the House Financial Services Committee, it is a pleasure to appear before you today as we continue working towards comprehensive reform of our financial system.

The Chairman and the Committee have made important progress over the past several weeks.

Against strong opposition, you have acted swiftly to lay the foundation for far-reaching reform that would better protect consumers from unfair and fraudulent lending practices, regulate the derivatives market, improve investor protection, reform credit rating agencies, and extend basic oversight to hedge funds and other unregulated financial entities.

Today, the Committee carries that momentum forward, tackling an extremely difficult and important issue: how to prevent excessive risk-taking by large financial firms and make sure that when those firms fail during a future crisis, the government can contain damage to the economy without imposing costs on taxpayers.

Over the past few decades, we have seen the significant growth of large, highly leveraged financial firms. These firms benefited from the perception that the government could not afford to let them fail, creating a classic moral hazard problem.

During the recent financial crisis, in order to preserve the stability of the financial system, protect the savings of Americans and prevent greater economic fallout, the government was forced to step in and stand behind almost all of these firms. That cannot happen again.

No financial system can operate efficiently if financial institutions and investors assume that the government will protect them from the consequences of failure. We cannot put taxpayers in the position of paying for the losses of large private financial institutions. We must build a system in which individual firms, no matter how large or important, can fail without risking catastrophic damage to the economy.

In June, the Administration outlined a comprehensive set of proposals to achieve this goal. Since then, after extensive work, the Chairman has drafted new legislation.

We believe that the test for any effective set of reforms is whether it has five key elements. And we believe that the Chairman's bill meets that test.

Orderly Resolution of Failing Financial Institutions

First, the federal government must have the ability to resolve failing major financial institutions in an orderly manner, with losses absorbed not by taxpayers but by equity holders, unsecured creditors and, if necessary, other large financial institutions.

In all but the rarest of cases, bankruptcy will remain the dominant tool for handling the failure of non-bank financial firms. But as the collapse of Lehman Brothers showed, the Bankruptcy Code is not an effective tool for resolving the failure of a global financial services firm in times of severe economic stress.

The Bankruptcy Code focuses almost exclusively on maximizing the interests of a firm's creditors, with little or no concern for spill-over effects on the financial system or the economy. It often moves too slowly. And it contains too few mechanisms for the stabilization of critical operations of a failed firm.

Recognizing this, Congress established a separate resolution regime for banks and thrifts, allowing the Federal Deposit Insurance Corporation (FDIC) to accomplish orderly failures of depository institutions. We need to adapt this effective and proven mechanism to address the significant risks associated with the failure of large financial institutions.

Under the proposed special resolution authority, a failing firm would be placed into an FDIC-managed receivership. The purpose of the receivership would be to unwind, dismantle, sell, or liquidate the firm in an orderly way that protects the financial system at lowest cost to taxpayers. Shareholders and other providers of regulatory capital of the failing firm would be forced to absorb losses, and managers responsible for the failure would be replaced.

Such an approach allows the government to reduce the risk that failure would result in panic by creditors and shareholders of other firms and helps maximize recovery of the value of the firm's assets.

Use of the proposed resolution authority would only be permissible if a financial firm is in default or in danger of imminent default; if the failure of the firm would have serious adverse effects on financial stability; and if use of the proposed regime would avoid or mitigate those adverse effects. We need strong checks and balances and any action would require agreement by the FDIC, the Federal Reserve, and the Treasury, in consultation with the President.

No Open-Bank Assistance to Failing Financial Institutions

The second element of effective reform is making sure that any individual firm that puts itself in a position where it cannot survive without special assistance from the government must face the consequences of failure.

The proposed resolution authority would not authorize the government to provide open-bank assistance to any failing firm. In other words, it would not permit the government to put money into a failing firm unless that firm is in government receivership and on the path to being unwound, sold or liquidated.

The authority would facilitate the orderly demise of a failing firm, not ensure its survival, and would strengthen market discipline and reduce moral hazard risks.

Protecting Taxpayers from Losses

The third element of effective reform is making sure that taxpayers are not on the hook for any losses that might result from the failure and subsequent resolution of a large financial firm.

The government should have the authority to recoup any such losses by assessing a fee on large financial firms. These assessments should be stretched out over time, as necessary, to avoid adding to the pressure induced by the crisis.

Such an ex-post funding mechanism has several advantages over an ex-ante fund. Most notably, it would generate less moral hazard because a standing fund would create expectations that the government would step in to protect shareholders and creditors from losses. In essence, a standing fund would be viewed as a form of insurance for those stakeholders.

Limiting the Federal Reserve's and the FDIC's Emergency Authorities

The fourth element of effective reform is limiting the emergency authorities of the FDIC and the Federal Reserve so that they are subject to appropriate checks and balances and can be used only to protect the financial system as a whole.

These authorities should only allow for temporary support, with an appropriate fee, that is designed to enable healthy institutions to continue operating and to prevent the disruption of credit flows during a severe economic downturn.

Specifically, the Federal Reserve's ability to extend credit to failing non-bank firms under section 13(3) of the Federal Reserve Act should be eliminated. Going forward, the Federal Reserve should be able to use 13(3) only to provide liquidity to solvent firms during periods of severe stress in the financial markets or US economy.

Use of the Federal Reserve's 13(3) authority should require prior written consent of the Treasury. With these reforms, the Federal Reserve would preserve its valuable central bank authority to act as the lender of last resort for a financial system in crisis, but would no longer be able to come to the rescue of failing firms such as Bear Stearns or AIG.

The FDIC should only be able to provide liquidity or guarantees to solvent non-bank financial firms with strong checks and balances. Any such use must be authorized by the Treasury and two-thirds of the boards of the Fed and the FDIC. In addition, any use must be recouped with assessments on the largest non-bank firms.

Stronger Constraints on Size and Leverage

The fifth element of effective reform is giving the federal government stronger supervisory and regulatory authority over major financial firms, and making sure that key financial markets and market infrastructure have buffers strong enough to absorb losses associated with periods of financial stress.

Regulators must be empowered with explicit authority to force major financial firms to reduce their size or restrict the scope of their activities when necessary to limit risk to the system. This is an important tool to deal with the risks posed by the largest, most interconnected financial firms.

Regulators must be able to impose tougher requirements – most crucially, stronger capital rules and more stringent liquidity standards – which would reduce the probability that major financial firms experience financial distress, either through capital depletion or a run by creditors. This would provide strong incentive for these firms to shrink, simplify, and reduce their leverage.

In addition, major firms must be subject to a prompt corrective action (PCA) regime and be required to prepare and regularly update what some have called "living wills," which are plans for their rapid resolution in the event of distress. These plans would leave us better prepared to deal with a firm's failure, and provide another incentive for firms to simplify their organizational structures and improve their risk management.

To build-up shock absorbers system-wide, all firms must face higher prudential requirements. We are negotiating a new international accord to establish a level playing field for capital requirements. This accord will raise capital requirements, improve the quality of capital, establish strong liquidity requirements that reduce reliance on unstable short-term funding, raise capital charges on more risky activities and help make regulation less pro-cyclical, so that they will more likely dampen rather that amplify future instability.

We must also improve supervision and regulation of derivatives markets and critical payment, clearing, and settlement systems; increase transparency throughout the financial system; and align incentives to improve securitization markets. This should be done at home and abroad.

Finally, we must close loopholes and reduce possibilities for gaming the system.

Monitoring threats to financial stability will fall to the proposed Financial Services Oversight Council. The Council would have the duty and authority to identify any financial firms whose size, leverage, complexity, and interconnectedness pose a systemic threat and require those firms to submit to a system of heightened supervision and regulation.

The Federal Reserve would oversee individual major financial firms so that there is clear, inescapable, single-point accountability. The Fed already supervises all major U.S. commercial banking organizations on a firm-wide basis and all major investment banks as well.

Conclusion

The current rules in place for our financial system are inadequate and outdated.

We have all experienced what happens when, during a crisis, the government is left with limited tools and limited choices. That is the searing lesson of last fall.

In today's markets, capital moves at speeds unimaginable when our current regulatory framework was created. And today's economy requires that Congress bring that framework into the 21st century, granting the government carefully constrained power to contain damage to the economy while managing the failure of large, complex financial institutions.

The bill before the Committee does that.

It represents a comprehensive, coordinated answer to the moral hazard problem posed by our largest, most interconnected financial institutions. It produces strong, accountable supervision of all our major financial firms and imposes costs not on the taxpayer but with the risk-takers, where they belong. It deters excessive risk taking and forces firms to better protect themselves against failure. It creates a strong, resilient, well-regulated financial system that can better absorb failure when it happens. And it establishes a resolution regime allowing the government, when the financial system is at risk, to unwind and break up a failing financial firm without imposing costs on taxpayers.

What this bill does not do is provide a government guarantee for troubled financial firms. It does not create a fixed list of systemically important financial firms. It does not create a permanent TARP-like authority. It does not give the government broad discretion to step in and rescue insolvent firms. And it does not give comfort to investors, creditors, counterparties, or management that the government will be there to absorb losses from risky business strategies.

With this bill we are looking forward, not backwards. We are looking to provide future Administrations with better options than existed last year. This is still an extremely sensitive moment for the financial system. Investors across the country and around the world are closely watching each step we take. And it is important for them to understand that the bill we are debating today is about giving the government better tools to deal with future crises, while we work to repair the damage caused by this crisis.

Mr. Chairman, the American people are counting on us to get this right and to get this done. You have made enormous progress already and we look forward to working with you so that we can put in place comprehensive reforms that will restore confidence in our financial system at home and abroad.

Thank you.