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Hearing on Systemic Risk and the Breakdown of Financial Governance

Senate Committee on Homeland Security and Governmental Affairs

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Good morning Chairman Lieberman and Senator Collins. My name is Damon Silvers and I am Associate General Counsel of the AFL-CIO and Deputy Chair of the Congressional Oversight Panel. My testimony today is on behalf of the AFL-CIO and will include a discussion of the Congressional Oversight Panel's report on regulatory reform mandated by the Emergency Economic Stabilization Act of 2008. However, my testimony reflects my views and those of the AFL-CIO, and does not necessarily reflect the views of the Congressional Oversight Panel, its chair or its staff. I have attached as appendices the regulatory reform report of the Congressional Oversight Panel, and recent statements of the AFL-CIO Executive Council addressing financial regulation.

This hearing has been called to address the question of how we should regulate systemic risk in the financial markets. The challenge of addressing systemic risk in the future is one, but by no means the only one, of the challenges facing Congress as Congress considers how to reregulate U.S. financial markets following the extraordinary events of the last eighteen months.

Systemic crises in financial markets harm working people. Damaged credit systems destroy jobs rather than create them. Pension funds with investments in panicked markets see their assets deteriorate. And the resulting instability undermines business' ability to plan and obtain financing for new investments—undermining the long term growth and competitiveness of employers and setting the stage for future job losses. The AFL-CIO has urged Congress since 2006 to act to reregulate shadow financial markets, and the AFL-CIO supports addressing systemic risk, but in a manner that does not substitute for strengthening the ongoing day to day regulatory framework, and that recognizes addressing systemic risk both requires regulatory powers and financial resources that can really only be wielded by a fully public body.

The concept of systemic risk is that financial market actors can create risk not just that their institutions or portfolios will fail, but risk that the failure of their enterprises will cause a broader failure of other financial institutions, and that such a chain of broader failures can jeopardize the functioning of financial markets as a whole. The mechanisms by which this broader failure can occur involve a loss of confidence in information, or a loss of confidence in market actors ability to understand the meaning of information, which leads to the withdrawal of liquidity from markets and market institutions. Because the failure of large financial institutions can have these consequence, systemic risk management generally is seen to both be about how to determine what to do when a systemically significant institution faces failure, and about how to regulated such institutions in advance to minimize the chances of systemic crises.

Historically, the United States has had three approaches to systemic risk. The first was prior to the founing of the Federal Reserve system, when there was a reluctance at the federal level to intervene in any respect in the workings of credit markets in particular and financial markets in

general. The Federal Reserve system, created after the financial collapse of 1907, ushered in an era where the federal government's role in addressing systemic risk largely consisted of sponsoring through the Federal Reserve system, a means of providing liquidity to member banks, and thus hopefully preventing the ultimate liquidity shortage that results from market participants losing confidence in the financial system as a whole.

But then, after the Crash of 1929 and the four years of Depression that followed, Congress and the Roosevelt Administration adopted a regulatory regime whose purpose was in a variety of ways to substantively regulate financial markets in an ongoing way. This new approach arose out of a sense among policymakers that the systemic financial crisis associated with the Great Depression resulted from the interaction of weakly regulated banks with largely unregulated securities markets, and that exposing depositors to these risks was a systemic problem in and of itself. Such centerpieces of our regulatory landscape as the Securities and Exchange Commission's disclosure based system of securities regulation and the Federal Deposit Insurance Corporation came into being not just as systems for protecting the economic interests of depositors or investors, but as mechanisms for ensuring systemic stability by, respectively, walling off bank depositors from broader market risks, and ensuring investors in securities markets had the information necessary to make it possible for market actors to police firm risk taking and to monitor the risks embedded in particular financial products.

In recent years, financial activity has moved away from regulated and transparent markets and institutions and into the so-called shadow markets. Regulatory barriers like the Glass-Steagall Act that once walled off less risky from more risky parts of the financial system have been weakened or dismantled. So we entered the recent period of extreme financial instability with an

approach to systemic risk that looked a lot like that of the period following the creation of the Federal Reserve Board but prior to the New Deal era. And so we saw the policy response to the initial phases of the current financial crisis primarily take the form of increasing liquidity into credit markets through interest rate reductions and increasingly liberal provision of credit to banks and then to non-bank financial institutions.

However, with the collapse of Lehman Brothers and the federal rescues of AIG, FNMA, and the FHLMC, the federal response to the perception of systemic risk turned toward much more aggressive interventions in an effort to ensure that after the collapse of Lehman Brothers, there would be no more defaults by large financial institutions. This approach was made somewhat more explicit with the passage of the Emergency Economic Stabilization Act of 2008 and the commencement of the TARP program. The reality was though that the TARP program was the creature of certain very broad passages in the bill, which generally was written with the view that the federal government would be embarking on the purchase of troubled assets, a very different approach than the direct infusions of equity capital that began with the Capital Purchase Program in October of 2008.

We can now learn some lessons from this experience for the management of systemic risk in the financial system.

First, our government and other governments around the world will step in when major financial institutions face bankruptcy. We do not live in a world of free market discipline when it comes to large financial institutions, and it seems unlikely we ever will. If two administrations as different as the Bush Administration and the Obama Administration agree that the federal government must act when major financial institutions fail, it is hard to imagine the

administration that would do differently. Since the beginning of 2008, we have used federal dollars in various ways to rescue either the debt or the equity holders or both at the following companies—Bear Stearns, Indymac, Washington Mutual, AIG, Merrill Lynch, Fannie Mae, Freddie Mac, Citigroup and Bank of America. But we have no clear governmental entity charged with making the decision over which company to rescue and which to let fail, no clear criteria for how to make such decisions, and no clear set of tools to use in stabilizing those that must be stabilized.

Second, we appear to be hopelessly confused as to what it means to stabilize a troubled financial institution to avoid systemic harm. We have a longstanding system of protecting small depositors in FDIC insured banks, and by the way policyholders in insurance companies through the state guarantee funds. The FDIC has a process for dealing with banks that fail—a process that does not always result in 100% recoveries for uninsured creditors. Then we have the steps taken by the Treasury Department and the Federal Reserve since Bear Stearns collapsed. At some companies, like Fannie Mae and Freddie Mac, those steps have guaranteed all creditors, but wiped out the equity holders. At other companies, like Bear Stearns, AIG, and Wachovia, while the equity holders survive, they have been massively diluted one way or another. At others, like Citigroup and Bank of America, the equity has been only modestly diluted when looked at on an upside basis. It is hard to understand exactly what has happened with the government's interaction with Morgan Stanley and Goldman Sachs, but again there has been very little equity dilution. And then there is poor Lehman Brothers, apparently the only non-systemic financial institution, where everybody lost. In crafting a systematic approach to systemically significant institutions, we should begin with the understanding that while a given

financial institution may be systemically significant, not every layer of its capital structure should be necessarily propped up with taxpayer funds.

Third, much regulatory thinking over the last couple of decades has been shaped by the idea that sophisticated parties should be allowed to act in financial markets without regulatory oversight. Candidly, institutional investors have been able to participate in a number of relatively lightly regulated markets based on this idea. But this idea is wrong. Big, reckless sophisticated parties have done a lot of damage to our financial system and to our economy. I do not mean to say that sophisticated parties in the business of risk taking should be regulated in the same way as auto insurers selling to the general public. But there has to be a level of transparency, accountability, and mandated risk management across the financial markets.

Fourth, financial markets are global now. Norwegian villages invest in U.S. mortgage backed securities. British bankruptcy laws govern the fate of U.S. clients of Lehman Brothers, an institution that appeared to be a U.S. institution. AIG, our largest insurance company, collapsed because of a London office that employed 300 of AIG's 500,000 employees. Chinese industrial workers riot when U.S. real estate prices fall. We increasingly live in a world where the least common denominator in financial regulation rules.

So what lessons should we take away for how to manage systemic risk in our financial system?

The Congressional Oversight Panel, in its report to Congress made the following points about addressing systemic risk.

- 1) There should be a body charged with monitoring sources of systemic risk in the financial system, but it could either be a new body, an existing agency, or a group of existing agencies;
- 2) The body charged with systemic risk managements should be fully accountable and transparent to the public in a manner that exceeds the general accountability mechanisms present in self-regulatory organizations;
- 3) We should not identify specific institutions in advance as too big to fail, but rather have a regulatory framework in which institutions have higher capital requirements and pay more on insurance funds on a percentage basis than smaller institutions which are less likely to be rescued as being too systemic to fail.
- 4) Systemic risk regulation cannot be a substitute for routine disclosure, accountability, safety and soundness, and consumer protection regulation of financial institutions and financial markets.
- 5) Ironically, effective protection against systemic risk requires that the shadow capital markets—institutions like hedge funds and products like credit derivatives—must not only be subject to systemic risk oriented oversight but must also be brought within a framework of routine capital market regulation by agencies like the Securities and Exchange Commission.
- 6) There are some specific problems in the regulation of financial markets, such as the issue of the incentives built into executive compensation plans and the conflict of interest

inherent in the credit rating agencies' business model of issuer pays, that need to be addressed to have a larger market environment where systemic risk is well managed.

- 7) Finally, there will not be effective reregulation of the financial markets without a global regulatory floor.

I would like to explain some of these principles and at least the thinking I brought to them. First, on the issue of a systemic risk monitor, while the Panel made no recommendation, I have come to believe that the best approach is a body made up of the key regulators. There are several reasons for this conclusion. First, this body must have as much access as possible to all information extant about the condition of the financial markets—including not just bank credit markets, but securities and commodities, and futures markets, and consumer credit markets. As long as we have the fragmented bank regulatory system we now have, this body would need access to information about the state of all deposit taking institutions. The reality of the interagency environment is that for information to flow freely, all the agencies involved need some level of involvement with the agency seeking the information. Connected with the information sharing issue is expertise. It is unlikely a systemic risk regulator would develop deep enough expertise on its own in all the possible relevant areas of financial activity. To be effective it would need to cooperate in the most serious way possible with all the routine regulators where the relevant expertise would be resident.

Second, this coordinating body must be fully public. While many have argued the need for this body to be fully public in the hope that would make for a more effective regulatory culture, the TARP experience highlights a much more bright line problem. An effective systemic risk regulator must have the power to bail out institutions, and the experience of the last year is that

liquidity provision is simply not enough in a real crisis. An organization that has the power to expend public funds to rescue private institutions must be a public organization—though it should be insulated from politics much as our other financial regulatory bodies are by independent agency structures.

Here is where the question of the role of the Federal Reserve comes in. A number of commentators and Fed officials have pointed out that the Fed has to be involved in any body with rescue powers because any rescue would be mounted with the Fed's money. However, the TARP experience suggests this is a serious oversimplification. While the Fed can offer liquidity, many actual bailouts require equity infusions, which the Fed cannot currently make, nor should it be able to, as long as the Fed continues to seek to exist as a not entirely public institution. In particular, the very bank holding companies the Fed regulates are involved in the governance of the regional Federal Reserve Banks that are responsible for carrying out the regulatory mission of the Fed, and would if the current structure were untouched, be involved in deciding which member banks or bank holding companies would receive taxpayer funds in a crisis.

These considerations also point out the tensions that exist between the Board of Governors of the Federal Reserve System's role as central banker, and the great importance of distance from the political process, and the necessity of political accountability and oversight once a body is charged with dispersing the public's money to private companies that are in trouble. That function must be executed publicly, and with clear oversight, or else there will be inevitable suspicions of favoritism that will be harmful to the political underpinnings of any stabilization effort. One benefit of a more collective approach to systemic risk monitoring is that the Federal

Reserve Board could participate in such a body while having to do much less restructuring that would likely be problematic in terms of its monetary policy activity.

On the issue of whether to identify and separately regulate systemically significant firms, another lesson of the last eighteen months is that the decision as to whether some or all of the investors and creditors of a financial firm must be rescued cannot be made in advance. In markets that are weak or panicked, a firm that was otherwise seen as not presenting a threat of systemic contagion might be seen as doing just that. Conversely, in a calm market environment, it may be the better course of action to let a troubled firm go bankrupt even if it is fairly large. Identifying firms ex ante as systemically significant also makes the moral hazard problems much more intense.

An area the Congressional Oversight Panel did not address explicitly is whether effective systemic risk management in a world of diversified institutions would require some type of universal systemic risk insurance program or tax. Such a program would appear to be necessary to the extent the federal government is accepting it may be in a position of rescuing financial institutions in the future. Such a program would be necessary both to cover the costs of such interventions and to balance the moral hazard issues associated with systemic risk management. However, there are practical problems defining what such a program would look like, who would be covered and how to set premiums. One approach would be to use a financial transactions tax as an approximation. The global labor movement has indicated its interest in such a tax on a global basis, in part to help fund global reregulation of financial markets.

More broadly, these issues return us to the question of whether the dismantling of the approach to systemic risk embodied in the Glass-Steagall Act was a mistake. We would appear now to be in a position where we cannot wall off more risky activities from less risky liabilities like

demand deposits or commercial paper that we wish to ensure. On the other hand, it seems mistaken to try and make large securities firms behave as if they were commercial banks. Those who want to maintain the current dominance of integrated bank holding companies in the securities business should have some burden of explaining how their securities businesses plan to act now that they have an implicit government guaranty.

Finally, the AFL-CIO believes very strongly that the regulation of the shadow markets, and of the capital markets as a whole cannot be shoved into the category labeled “systemic risk regulation,” and then have that category be effectively a sort of night watchman effort. The lesson of the failure of the Federal Reserve to use its consumer protection powers to address the rampant abuses in the mortgage industry earlier in this decade is just one of several examples going to the point that without effective routine regulation of financial markets, efforts to minimize the risk of further systemic breakdowns are unlikely to succeed. We even more particularly oppose this type of formulation that then hands responsibility in the area of systemic risk regulation over to self-regulatory bodies.

As Congress moves forward to address systemic risk management, one area that we believe deserves careful consideration is how much power to give to a body charged with systemic risk management to intervene in routine regulatory policies and practices. There are a range of options, ranging from power so broad it would amount to creating a single financial services superregulator, e.g. vesting such power in staff or a board chairman acting in an executive capacity, to arrangements requiring votes or supermajorities, to a system where the systemic risk regulator is more of scout than a real regulator, limited in its power to making recommendations to the larger regulatory community. The AFL-CIO would tend to favor a choice somewhere

more in the middle of that continuum, but we think this is an area where further study might help policymakers formulate a well-founded approach.

Finally, with respect to the jurisdiction and the reach of a systemic risk regulator, we believe it must not be confined to institutions per se, or products or markets, but must extend to all financial activity.

In conclusion, the Congressional Oversight Panel's report lays out some basic principles that as a Panel member I hope will be of use to this Committee and to Congress in thinking through the challenges involved in rebuilding a more comprehensive approach to systemic risk. The AFL-CIO is very concerned that as Congress approaches the issue of systemic risk it does so in a way that bolsters a broader reregulation of our financial markets, and does not become an excuse for not engaging in that needed broader reregulation. Thank you.