

**IMPLICATIONS OF THE “VOLCKER RULES” FOR
FINANCIAL STABILITY**

HEARING
BEFORE THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED ELEVENTH CONGRESS
SECOND SESSION
ON
EXAMINING THE IMPLICATIONS OF THE “VOLCKER RULES” FOR
FINANCIAL STABILITY

—————
FEBRUARY 4, 2010
—————

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



Available at: <http://www.access.gpo.gov/congress/senate/senate05sh.html>

—————
U.S. GOVERNMENT PRINTING OFFICE

61-651 PDF

WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office,
<http://bookstore.gpo.gov>. For more information, contact the GPO Customer Contact Center,
U.S. Government Printing Office. Phone 202-512-1800, or 866-512-1800 (toll-free). E-mail, gpo@custhelp.com.

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CHRISTOPHER J. DODD, Connecticut, *Chairman*

TIM JOHNSON, South Dakota	RICHARD C. SHELBY, Alabama
JACK REED, Rhode Island	ROBERT F. BENNETT, Utah
CHARLES E. SCHUMER, New York	JIM BUNNING, Kentucky
EVAN BAYH, Indiana	MIKE CRAPO, Idaho
ROBERT MENENDEZ, New Jersey	BOB CORKER, Tennessee
DANIEL K. AKAKA, Hawaii	JIM DEMINT, South Carolina
SHERROD BROWN, Ohio	DAVID VITTER, Louisiana
JON TESTER, Montana	MIKE JOHANNIS, Nebraska
HERB KOHL, Wisconsin	KAY BAILEY HUTCHISON, Texas
MARK R. WARNER, Virginia	JUDD GREGG, New Hampshire
JEFF MERKLEY, Oregon	
MICHAEL F. BENNETT, Colorado	

EDWARD SILVERMAN, *Staff Director*

WILLIAM D. DUHNKE, *Republican Staff Director*

MARC JARSULIC, *Chief Economist*

JOE HEPP, *Professional Staff Member*

AMY S. FRIEND, *Chief Counsel*

DREW COLBERT, *Legislative Assistant*

MARK OESTERLE, *Republican Chief Counsel*

HEATH P. TARBERT, *Republican Special Counsel*

JEFFREY M. WRASE, *Republican Chief Economist*

RHYSE NANCE, *Republican Professional Staff Member*

DAWN RATLIFF, *Chief Clerk*

DEVIN HARTLEY, *Hearing Clerk*

SHELVIN SIMMONS, *IT Director*

JIM CROWELL, *Editor*

C O N T E N T S

TUESDAY, FEBRUARY 4, 2010

	Page
Opening statement of Chairman Dodd	1
Opening statements, comments, or prepared statements of:	
Senator Shelby	
Prepared statement	39
WITNESSES	
E. Gerald Corrigan, Managing Director, Goldman, Sachs and Co.	4
Prepared statement	39
Simon Johnson, Ronald A. Kurtz Professor of Entrepreneurship, Sloan School of Management, Massachusetts Institute of Technology	6
Prepared statement	45
John Reed, Retired Chairman, Citigroup	7
Prepared statement	49
Hal S. Scott, Nomura Professor of International Systems, Harvard Law School	9
Prepared statement	50
Barry L. Zubrow, Executive Vice President and Chief Risk Officer, JPMorgan Chase and Company	11
Prepared statement	63

IMPLICATIONS OF THE “VOLCKER RULES” FOR FINANCIAL STABILITY

TUESDAY, FEBRUARY 4, 2010

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:39 p.m., in room SD-538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order. Let me first of all apologize to my colleagues and our witnesses. I was just chatting with Senator Shelby. Our colleagues from North Carolina invited me to come by this morning and speak to the North Carolinian community bankers, and so—I can see all the heads nodding. I am going to be speaking to every community banking group here on this table, I guess, before long. But I spent a few extra minutes with them and I apologize for being a few minutes late.

Senator WARNER. You have some extra time now.

Chairman DODD. I am sorry, Senator?

Senator WARNER. You have some extra time on your hands.

Chairman DODD. Yes, extra time on my hands.

Senator JOHNSON. The South Dakota community—

Chairman DODD. South Dakota, that will be next.

Well, we are going to meet again this morning. As all of you know, we met last Tuesday, or this Tuesday, with Paul Volcker and Neal Wolin who testified about the so-called “Volcker Rule” and we welcome our witnesses here this morning, as well, many of whom I know well and some I am welcoming back to the Committee. Mr. Reed, it is good to see you again back before this Committee. It has been a long time and you are always welcomed here.

The “Implications of the ‘Volcker Rules’ for Financial Stability.” And I am going to make a couple of brief opening comments, turn to Senator Shelby, and then we will turn to our witnesses, beginning with you, Gerry, at that end of the table, and then work down. I will ask you to be relatively brief, if you can, in your comments. I read, Gerry, your testimony—there is nothing brief about your testimony—last evening, another voluminous and—

Mr. CORRIGAN. I cannot resist.

Chairman DODD. I know. Everything is big at Goldman, you know.

[Laughter.]

Chairman DODD. So we are going to make sure it is included in the record, along with any other supporting documents and evidence that all of you would like to offer this morning, and then I will turn to my colleagues for some questions here.

We have some votes around 12:30, so we are going to try and move along if we can this morning, rather than bring you back again in the afternoon. I again thank all of you for being here.

As I said a moment ago, this is our second hearing this week on the Obama administration's proposal to crack down on excessive consolidation and risk taking within our financial system.

I would like to start by clarifying something that I said on Tuesday. Folks may have noticed I sounded a little frustrated, and they were correct in that observation. The fact is, I think all of us are to one degree or another frustrated with the present situation in our country and all anxious to see us get back on our feet and back on track again.

The issues that Senator Shelby and I and the Members of the Committee are grappling with are difficult, they are complicated, and they are terribly important. But as we have been debating them for months—in fact, some of these issues we have been debating for years in this institution as well as elsewhere. But nearly 2 years after the collapse of Bear Stearns, we still have not updated the laws governing our financial sector, leaving our fragile economy with the same vulnerabilities that led to the economic crisis in the first place. I think we are at a critical point and juncture at this particular hour.

Now, as my colleagues know, I laid out a discussion draft in November and Members of this Committee have been working together across the aisle to come up with a compromise, if we can, ever since, and I thank all of them. This has been a very difficult job, but they have spent countless hours on working on proposals here that we could present to our colleagues, and more importantly, to the country as to how we think we ought to fill in these gaps and move forward. We are now getting to the point where we need to sort of pull the trigger, in a sense, because hard-working American families can't wait much longer for a return to economic security and certainty.

If I have heard one word over and over and over again, it is the lack of certainty that is out there, and part of our job is to help clarify and provide some certainty as to where we are headed, and our hope is with our legislation to do that.

It is tough to take on another issue at this point. I made that point. There are wonderful ideas out there. There are a lot of things that we need to be talking about in the area of financial services. It was never my intention or, I believe, the intention of this Committee to solve every issue surrounding the financial services sector. We tried to focus on some critical ones that we think would make a fundamental difference, but never the assumption we could take on all the issues that people would like to raise in a moment like this.

And we need to not only talk about filling in the gaps of the problems that existed, but looking ahead, which is our responsibility. What can we do to set up an architecture that would minimize the kind of problems we saw occurring again. If not in this

particular environment or sector, where else could they emerge? And are we building the structural institutions that will minimize that from happening again beyond what we can imagine today, something 10 years, 20 years from now? And that is also part of our function and obligation, in my view, on this Committee.

But while the specific proposals announced by the Administration have come late in the game, they deserve our serious consideration, as well, and I believe the Administration is on the right track, but finding a way to implement these proposals is no easy feat, as well. These are complicated issues meant to address complicated problems that leave our Nation's economy at risk and we need to find a balance between giving them their due consideration and appreciating the urgency with which we need to act given what is at stake.

On Tuesday, we heard from Chairman Volcker and Treasury Secretary Wolin, and I appreciate the strong cases that they made for the Administration's proposals, as well as their thoughts on how we ought to move forward.

Today, we have before us a very impressive panel of experts from the industry and academia to discuss the possible consequences of these proposals. I look forward to hearing from each and every one of you. What is more, I understand that for our industry friends, this might be a little like walking into the lion's den. But our intention here is to probe these ideas and solicit your thoughts and background and experience as to how to move forward.

Let me just say, we did not embark on financial reform because we wanted to punish the industry. I certainly didn't, at all. We all want to create a system where business, large and small, can thrive, and that the users, the customers, the people who come through your doors, can have that confidence restored that our system is sound, it is safe, and they can rely on it, whether depositing their paycheck, buying a stock, an insurance policy, taking out a mortgage. It is the people not in this room today that want to know whether or not we get it and you get it, and we are going to create that structure that allows them then to have that sense of confidence and optimism that is the critical element for our economy recovery, in my view.

So I have heard the arguments again and the industry's refusal, and I am not going to single out our witnesses, but the refusal of large firms to work constructively with Congress on this effort. It borders on insulting to the American people who have lost so much in this crisis. And from where I am sitting, it looks like instead of investing in improvements that would secure their financial strength, too many people in the industry have decided to invest in an army of lobbyists whose only mission is to kill the common sense financial reforms that we are working so hard up here to try to achieve, and we have been working on for a number of months.

I have heard all the arguments for business as usual, but the American people have been through too much. Unemployment is still too high. The economy remains too vulnerable to support the *status quo*. That is unacceptable and we need to move forward.

So I am determined as ever to get this strong bill to the floor of the Senate in an appropriate amount of time to allow full consideration of us here on this Committee and then by our colleagues, and

then to work out our differences with the House and put a bill on the desk for his signature.

So with that, let me turn to Senator Shelby for any opening comments, and then we will turn to our witnesses.

Senator SHELBY. Mr. Chairman, I would just like to ask you to put my statement in the record so we can go on with the panel.

Chairman DODD. Done. Consider it done.

Does anyone feel obligated to speak? Otherwise, the Corker Rule prevails.

Our first witness is Gerald Corrigan, Managing Director with Goldman Sachs. He has been there for a long time. Prior to that, he was the Vice Chairman of the Federal Open Market Committee. Mr. Corrigan is also a native of the town of Waterbury, Connecticut. We don't often get to say that about witnesses here, that they come from Connecticut. We are proud of Gerry. He earned his Bachelor's degree from Fairfield University in Connecticut, as well.

Simon Johnson is the Ronald A. Kurtz Professor of Entrepreneurship at MIT Sloan School of Management. He also serves as a Senior Fellow at the Peterson Institute for International Economics. Previously, Professor Johnson was the IMF's Chief Economist, from 2007 to 2008.

John Reed, I have already mentioned here, is the former Chairman of Citigroup. He was also Chairman of the New York Stock Exchange from 2003 to 2005. He currently serves on the MIT Leadership Center Advisory Council, and John, we welcome you back to the Committee.

Hal Scott is the Nomura Professor and Director of the Program of International Financial Systems at the Harvard Law School. Again, he has been before this Committee on numerous occasions in the past. He has taught there since 1975. Much of his work focuses on international financial issues. He is also the Director of the Nonprofit Committee on Capital Markets Regulation.

And Barry Zubrow, again, who we know well, is the Chief Risk Officer and Executive Vice President for JPMorgan Chase, and again, someone we are very familiar with on this Committee. Prior to that, he was the Chief Operating Officer of Goldman Sachs, where he has worked since 1979.

We thank all of you for being here this morning on relatively short notice, as well, to share your thoughts on this issue and related matters, and Gerry, we will begin with you.

**STATEMENT OF E. GERALD CORRIGAN, MANAGING DIRECTOR,
GOLDMAN, SACHS AND CO.**

Mr. CORRIGAN. Thank you very much, Mr. Chairman. I have again provided the Committee with a rather long statement which seeks to provide for you and your staffs some meaningful perspective on this financial reform process as a whole. And trust me, I am not going to go into the details of that, except to say that one key fact that we have to keep in mind throughout these deliberations is that the single most important proximate cause of the financial crisis was lending in all of its forms. I might just remind the Committee, probably not necessary, that based on my association with crises back in the 1980s and early 1990s, that was also true in those episodes, as well.

My starting point for all of this, Mr. Chairman, is that I fully and enthusiastically agree that we have to put “too big to fail” behind us. My statement includes a summary of what I consider to be the financial reform agenda, the architecture, to use the word that you used, Mr. Chairman, and all I would say about that is that it is urgent that we move ahead with this. The execution will be very challenging. It is a package deal. If you fail on part of it, it will compromise other parts of it. And again, it is just a very, very difficult task.

I think as a matter of perspective, it is important to keep in mind that there are a rich framework for existing rules and regulations out there already that are being enhanced by the legislative process that I think deal quite effectively with some of the issues that were raised by Chairman Volcker. I certainly do think that well managed and well supervised large institutions play a necessary and constructive role.

Now, with regard to the Volcker plan itself, I would just make a couple of quick introductory remarks. First of all, there are many important definitional and details that yet need to be clarified, and in those circumstances, I have to say that it is not at all clear to me, at least at this stage, that the focus is on the issues that really were at the heart of the crisis itself. Certainly, we need greater clarification on that.

Much of the focus is on so-called “proprietary trading,” and that, too, is a very difficult subject to define. But what I can say, based on my own kind of common sense effort to define proprietary trading at Goldman Sachs, is that over the cycle, the net revenues associated with so-called “proprietary trading” are 10 percent or less of firmwide revenues at Goldman Sachs.

I also think that client-driven market making and hedging and risk management activities are, in my judgment, natural activities for well managed and well supervised banking groups. I think the outliers can be dealt with on a case-by-case basis, either with existing rules, much less with the enhanced rules that I am sure will flow out of the reform process.

I also included in my statement, Mr. Chairman, a discussion of the issues associated with resolution authority, and resolution authority is critical to dealing with the “too big to fail” problem. And I have spelled out certain principles and prerequisites that I think are absolutely essential if we are to make resolution authority work, and ultimately, that, together with the other parts of the agenda I have specified, is how we will find success in the future and a safer, sounder, and more efficient financial system, while at the same time putting “too big to fail” behind us.

I should also in closing, Mr. Chairman, say that, as I think you and others know, my respect and admiration for Chairman Volcker is unlimited. He is, in my judgment, one of the great, great figures of the past half-century or more. So it is not altogether the easiest thing in the world for me to take exception at least with some of the details that the Chairman has suggested. But I want to assure you and everyone else that I have more respect and more admiration for Paul Volcker than I do for any man or woman alive.

Thank you very much, Mr. Chairman.

Chairman DODD. Thank you very much, Gerry. I appreciate it very much.

Mr. Johnson.

STATEMENT OF SIMON JOHNSON, RONALD A. KURTZ PROFESSOR OF ENTREPRENEURSHIP, SLOAN SCHOOL OF MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. JOHNSON. Thank you, Senator. I strongly support the Volcker Rules, as everybody is starting to call them, in terms of the principles they put forward.

I think there are two main principles. The first is that we should redesign the size cap that does already exist for U.S. banks, the size cap from the 1994 Riegle-Neal Act. We should redesign it to reflect current realities. And second, we should address the issue that has arisen, in particular over the past few years, of U.S. Government backing for very large financial enterprises that have basically an unlimited ability to take risk around the world.

I do not, however, think that the exact formulation of the Volcker Rules as put forward is the right way to go. I think, actually, you should consider tightening the restrictions on the largest banks and reducing the size cap, and I would emphasize that our banks are now already much larger as a percent of the—our largest banks as a percent of the economy, a percent of total financial assets, than we have ever seen before in the United States.

Our largest six banks have assets worth over 60 percent of GDP. This reflects, in addition to what has happened in the financial crisis and the bailout and the rescue, it reflects the underlying concentration of these financial markets. So the big four banks now have more than half of the mortgage market in this country and two-thirds of the market for credit cards. This is unfair competition. Because these banks are too big to fail, they have lower funding costs, they are able to attract more capital, they make more money over the cycle, and they continue to get larger. And I do not think that we have seen the end of this.

If you look at the European situation today, for example, it is much worse than what we have in this country with regard to the size of the largest banks. Just as one example, the Royal Bank of Scotland peaked with total assets at 125 percent of U.K. GDP. That is a seriously troubled bank that is now the responsibility of the U.K. taxpayer. If we allow our biggest banks to continue to build on these unfair market advantages and the lower funding costs, we will head in the same direction.

I think I would suggest to you that you consider imposing a size cap on banks relative not to total normal assets or liabilities, which is the Volcker proposal, because that is not bubble-proof. If you have a massive increase in house prices, real estate prices, such as happened in Japan in the 1980s, you will have a big increase in the normal size of bank balance sheets. And when the bubble bursts, you are going to have a big problem. I think the size cap should be redefined as a percent of GDP.

And I think that while the science on bank size is, to be sure, incomplete and inexact, there is no evidence that I can find of any kind, and I have spent a lot of time talking to technical people from the financial sector and people at central banks, people in the

banking system themselves have impressed various points on me. I cannot find anything—I put this in the written testimony—that supports the idea that societies such as ours should have banks with total assets larger than around \$100 billion in today's money.

Now, if you were to impose a size cap of, say, 3 or 5 percent of GDP, no bank can be larger than that size, that would return our biggest banks roughly to the position that they had in the early 1990s. Now, our financial system worked very well in the early 1990s. Goldman Sachs, as one example, was one of the world's top investment banks. I don't think anyone questioned the competitive sector. But since the early 1990s, we have developed a lot more system risk focused on the existence of these very big banks.

So, as Mr. Corrigan said, the essence of this crisis was lending, but it was lending that at the heart of it was based on the idea you could make nonrecourse loans to people who can walk away from their homes when the house value falls, leaving the bank with huge losses. How do people think this was a good idea? Why did they think that this would survive as a business model? Well, I think it was very much about the size of these banks and very much about the support they expected to receive when they are under duress.

So in conclusion, I think the Volcker principles are exactly right. I think they are long overdue. I think you should—I hope that you will take them up and develop them further. I think the degree of unfair market competition, the degree to which the community banks are disadvantaged by the current situation, because they have to pay a lot more money—they pay higher interest for funds, their cost of capital is higher—this is unfair. This dynamic will continue unless you put an effective cap on it. The biggest banks will become even larger and even more dangerous.

Thank you very much.

Chairman DODD. Thank you very much.

John, welcome again.

STATEMENT OF JOHN REED, RETIRED CHAIRMAN, CITIGROUP

Mr. REED. Mr. Chairman, thank you very much for your kind welcome. Senator Shelby and everybody, I appreciate the opportunity to be with you. I had never anticipated as a retired citizen that I would find myself here, but I really am here to voice support for Mr. Volcker's suggestion, the Volcker Rule.

I do think that while details have to be worked out and so forth, I think that it is a good suggestion and one that is worthy of consideration by this Committee and the Congress in general.

I don't say this because I think the absence of that rule was central to the difficulties that we have just come through. I don't think that is the case. But I do say it from the point of view that if we were take a blank piece of paper and we were to say to ourselves, how can we design a financial system that would both serve the public and also be relatively safe and relatively unlikely to have a repeat of what we had, you would start out certainly with capital, which needs to be augmented.

You would certainly look at the structure of the regulatory framework, which I believe this Committee is doing. But I would argue that you would also look to maybe compartmentalize the in-

dustry, not deny any function to the industry in general, but compartmentalize it so as to limit economic spillover.

But as somebody who has run a large company in this industry for a long time, because of the impact that it has on the culture and the makeup of the various firms, dealing with the capital markets, proprietary trading, proprietary investing, hedge fund market, so forth and so on, each of these bring with them their own culture. These are cultures that have to exist for the particular purpose, but they have their own particular characteristics and there is no question in my mind but these cultures have an impact on the institution within which they are embedded.

And if I were asked to design a system, I would not allow these kind of cultures and activities to be a part of large depository and traditional lending institutions. It is not that I feel these functions shouldn't exist. I would simply separate them from institutions that are the deposit takers and basically the traditional lenders for much of the economy. And I do this because I think the culture from the capital markets that rubs off has to do with risk taking. It certainly has to do with compensation, and it has to do with the nature of the human fabric of the various entities that we are talking about.

So I believe as a part of a comprehensive reform that Mr. Volcker's idea with regard to separation of some of these functions makes a lot of sense, not because I am concerned about the economics, but because I am concerned of the nature of the impact that these various activities have on the players and the financial markets.

With regard to size, I would differ a little bit with Professor Johnson. I think the antitrust laws are quite capable of dealing with size in the marketplace. The place where size is the problem has to do with the intra-industry transactions, the so-called "counterparty risk." This is where the "too big to fail" comes into play. It isn't the balance sheet of the bank that is the problem on "too big to fail." It is the interconnectedness of one financial institution with virtually all other financial institutions. And so this is where I believe we must be concerned about size.

You could deal with size by having capital requirements that relate to the size of intra-industry activity, and obviously increasing capital as intra-industry activity goes up. You also, and this has been proposed and I think it is a good idea, can ask that certain instruments be traded through exchanges. This acts as a circuit breaker, the exchanges. It acts as a circuit breaker in the transmission of difficulties. And you could deal with size by simply putting limitations on counterparty risk, on the degree of leverage that can exist with regard to intra-industry trading.

So the issue of size, I think, is also relevant, and so I think the two keys to Mr. Volcker's suggestion, that of segregation of function within the industry and particularly the protection of the large deposit-taking institutions and the idea of being concerned about size, have merit and deserve the consideration of this Committee.

A final comment, if I could. I believe that one of the reasons that JPMorgan Chase did better than many others during this recent crisis is they did not have embedded in that institution a real money market activity, a trading house. JPMorgan Chase was the

amalgam of about five commercial banks, but none of them had a big investment banking trading activity in it, and the absence of that kind of function turned out in the crisis to give them a relative strengthened position.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very, very much.

Mr. Scott, welcome back to the Committee.

**STATEMENT OF HAL S. SCOTT, NOMURA PROFESSOR OF
INTERNATIONAL SYSTEMS, HARVARD LAW SCHOOL**

Mr. SCOTT. Thank you. Thank you, Chairman Dodd, Ranking Member Shelby, and Members of the Committee for permitting me to testify before you today on the Volcker rules and related size limitations.

Chairman DODD. Mr. Scott, I am going to interrupt you for a minute if I can here. I rarely get a full quorum in the Committee, and we have got one here for at least a couple of minutes. We have some nominees that I am going to quickly try and take care of. I do not think they cause any controversy, but I will take a fair crack at it anyway.

[Whereupon, at 11:04 a.m., the Committee proceeded to other business and reconvened at 11:05 a.m.]

Chairman DODD. The Committee will now turn to Professor Scott. How was that for speed? If I can just get financial reform through.

[Laughter.]

Chairman DODD. I was going to slip it in. Smuggle it in.

Senator SHELBY. Maybe you can.

[Laughter.]

Mr. SCOTT. This Committee has been hard at work for several months on a broad range of issues of financial reform that are crucial to our Nation's future, including new resolution procedures to protect the taxpayers from loss, reduction of systemic risk through better capital requirements and central clearing for over-the-counter derivatives, and enhanced measures of consumer protection.

Less than 2 weeks ago, the Administration announced the so-called "Volcker rules." Whatever one thinks of the merits of these new proposals, it is undeniable that they will take considerable time to develop and debate. Tuesday's hearing certainly underscored this point. These new proposals should not hold up action on the pressing fundamental issues much further down the track, and I encourage this Committee's continuing efforts to reach a bipartisan consensus on these issues.

The asserted objective of the new proposed rules is to limit systemic risk. In my judgment, they fail to do so. If the limits on proprietary trading only apply where banking organizations take positions "unrelated to serving customers," they will have little impact. For example, with respect to Wells Fargo and Bank of America, such activity represents around 1 percent of revenues. While this has been estimated to be 10 percent of the revenues of Goldman Sachs, Goldman could easily avoid the requirements by divesting itself of its banking operations since deposit-taking constitutes only 5.19 percent of its liabilities.

The real source of systemic risk in the banking system, as demonstrated by this crisis, is old-fashioned lending. It was mortgage lending that was at the heart of the financial crisis.

I do not agree with Mr. Volcker that these traditional activities, by the way, are entitled to a safety net. Banks should not be bailed out, whatever the reason for their losses. Indeed, the focus should be, as it is in the pending legislation, to control risky activities of whatever kind.

The Volcker rules would also prohibit banks from investing in, or sponsoring, private equity including venture capital funds. This would have little impact on the large banks whose investment in private equity accounted for less than 2 percent of their balance sheets.

On the other hand, bank private equity investments are important to the private equity industry as a whole, accounting for \$115 billion or 12 percent of private equity investment. Depriving the industry of this important source of funds could impede our economic recovery.

Turning to the size limitation proposal, let me stress that this proposal does not purport to decrease the present size of any U.S. financial institution nor would it prevent any financial institution from increasing its size through internal growth. The proposal, as I understand it, would only limit the growth of nondeposit liabilities achieved through acquisition.

Accordingly, if banks or other financial institutions are too big to fail, this proposal will have no impact on them. Indeed, it even permits them to get bigger.

In thinking about size, our concern should be with the size of a bank or other financial institution's interconnected positions, not its total size, because it is the degree of interconnectedness that drives bailouts, and here I fully agree with what Mr. Reed said on this. I fail to see how market share of nondeposit liabilities could be a proxy for position size.

Let me briefly turn to the international context. Without international consensus, adopting these proposals will only harm the competitive position of U.S. financial institutions. These proposals have not been agreed to, even in principle, by the G-20 or major market competitors, unlike most of the other proposals that the House has considered and that are presently before your Committee. While major market leaders and international organizations have been polite in welcoming these proposals, they have not endorsed them.

In conclusion, do these proposals deserve further consideration and debate? Absolutely.

But are they central to reform? In my view, they are not, and I would stress the fact that they should not in any event hold up action on the complex matters already before your Committee.

Thank you.

Chairman DODD. Thank you very, very much.

Mr. Zubrow, welcome to the Committee again.

STATEMENT OF BARRY L. ZUBROW, EXECUTIVE VICE PRESIDENT AND CHIEF RISK OFFICER, JPMORGAN CHASE AND COMPANY

Mr. ZUBROW. Thank you very much, Chairman Dodd, Ranking Member Shelby, Members of the Committee. Thank you for giving us the opportunity to appear this morning.

While the history of the financial crisis has yet to be written conclusively, we know enough about the causes to recognize that we need substantial regulatory reform. Our current framework was patched together over many decades. When it was tested, we saw its flaws all too clearly.

Mr. Chairman, I want to assure you and the other Members of the Committee that we strongly support your efforts to craft and pass meaningful regulatory legislation. In our view, the markets and the economy reflect continued uncertainty about the regulatory environment. However, the details matter a great deal, and a bill that creates further uncertainty or undermines the competitiveness of the U.S. financial sector will not serve our goal of a strong, stable economy.

At a minimum, we need a systemic regulator to monitor risk across our financial system. In addition, as we at JPMorgan Chase have stated repeatedly, no firm, including our own, should be too big to fail. Regulators need enhanced resolution authority to wind down failing firms, in a controlled way that does not put taxpayers' dollars at risk or the broader economy at risk.

Other aspects of the regulatory system also need to be strengthened, including consumer protection, capital standards and the oversight of OTC derivatives. But I emphasize systemic risk regulation and resolution authority because they provide a useful framework for consideration of the most recent proposals from the Administration.

Two weeks ago, the Administration proposed new restrictions on certain activities related to proprietary trading, hedge funds and private equity. The new proposals are a divergence from the hard work being done by legislators, central banks and regulators around the world to address the root causes of the financial crisis and to establish robust mechanisms to properly regulate systemically important financial institutions. While there may be valid reasons to examine these activities, there should be no misunderstanding. The activities the Administration proposes to restrict did not cause the financial crisis.

Further, regulators currently have the authority to ensure that these risks are adequately managed in the areas that the Administration proposes to restrict. We need to take the next logical step of extending these authorities to all systemically important firms regardless of their legal structure. If the last 2 years have taught us anything, it is that threats to our financial system can and do originate in nondepository institutions.

Thus, any new regulatory framework should reach all systemically important entities, including investment banks whether or not they have insured deposits. All systemically important institutions should be regulated to the same rigorous standards. If we leave some firms outside the scope of this regulation framework, we will be right back where we were before the crisis started. We

cannot have two tiers of regulation for these systemically important, interconnected firms.

As I noted at the outset, it is also very important that we get the details right. Thus far, the Administration has offered few details on what is meant about proprietary trading. Any individual trade taken in isolation might appear to be proprietary trading, but in fact is part of a mosaic of serving clients and properly managing the firm's risks. If defined improperly, this proposal could reduce the safety and soundness of our banking institutions, raise the cost of capital formation and restrict the availability of credit for businesses, large and small, all with no commensurate benefit to reducing systemic risk.

Similarly, the Administration has yet to define what ownership or sponsorship of hedge funds and private equity activities means. Asset managers, including JPMorgan, serve a broad range of clients including individuals, universities and pensions, and need to offer these investors a broad range of investment opportunities across all types of asset classes. In each case, investments are designed to meet the needs of our clients. While we agree that the United States must show leadership in regulating financial firms, if we take an approach that is out of sync with other major countries, without any demonstrable risk reduction benefit, we will dramatically weaken our firms' ability to serve our clients in this Country.

The Administration also proposed certain limits on the size of financial firms. If you consider the institutions that failed during the crisis, some of the largest and most consequential failures were standalone investment banks, mortgage companies, thrifts and insurance companies, not the diversified financial firms that appear to be the target of the Administration's proposals. It is not AIG's or Bear Stearns's size that led to their problems, but rather the interconnection of those firms that required the Government to step in.

In fact, our capabilities, size and diversity were essential to both withstanding the impacts of the crisis and emerging as a stronger firm, but equally importantly putting us in a position to acquire Bear Stearns and Washington Mutual when the Government asked us to help.

An artificial cap on liabilities will likely have significant negative consequences. Banks' liabilities and capital support the asset growth of their lending activities. By artificially capping liabilities, banks may be incented to reduce the growth of assets or the size of their existing balance sheets, which in turn would restrict our ability to make loans to consumers, to businesses, as well as to invest in Government securities.

While numerical limits and strict rules may sound simple. There is great potential that they would undermine the goals of economic stability, growth and job creation. The better solution is modernization of our financial regulatory regime that gives regulators the authority and the resources needed to do the rigorous oversight involved in examining firms' balance sheets and lending practices.

Let me conclude by just noting that it is vital that you as policy-makers and those like us, with a stake in our financial system, work together to overhaul regulation thoughtfully and well. While

the specific changes may seem arcane and technical, they are critical to the future of our economy. We look forward to working with the Committee to enact reforms that will position our financial industry and economy for sustained growth for decades to come.

Thank you and I look forward to your questions.

Chairman DODD. Thank you very, very much.

I will ask the clerk to put on, let's say, 6 minutes. So we will try and get through. We have a lot of good participation here this morning.

Let me begin on the issue and ask all of you briefly to comment on it. There are a lot of issues surrounding this proposal, and I am going to focus on the issue of the proprietary trading side. I think some of you made a pretty good case, and I find myself sympathetic to the notion of the size question, that this is very difficult. It is the interconnectedness that I think makes a lot of sense to me.

So, in my time, I want to focus on the other matter where there seems to be a little bit more of diversity of opinion, and the issue is the effective ability, in my view, to effectively draw that bright line between proprietary trading and these other activities.

I know there was some interest. Bob Diamond, who is the CEO of Barclays, reportedly made a speech in this recent matter at a gathering in Switzerland. Let me tell you the quote. He said, and I am quoting here. This is the report of the quote: "It is very, very difficult to think that we can differentiate between the risk bank's stake and the normal course of business for their clients and customers and proprietary trading."

Then another of his colleagues, apparently at the same setting, said the following: "I can find a way to say that virtually any trade we make is somehow related to serving one of our clients. They can go ahead and impose the rule on Friday, and I can assure you that by Monday we will find a way around it. Nothing will change unless the definition is ironclad."

Now I do not know who said that at that meeting, but that was the report of the meeting. And I have said that yesterday as well, that before even the ink dries on a proposal here, there will be very bright, young people who will sit and figure out some way to do a dodge. Is that your conclusion?

Putting aside whether or not you agree whether we ought to do it or not, can we write such a thing here that would be ironclad, that would actually prohibit this kind of activities, and to such a degree?

John, why do you not go ahead?

Mr. REED. Mr. Chairman, I believe you can. If you run a bank, you know what you are doing. You have to have limits for the various activities in your trading floor. There is no question that people can cheat and break rules. It happens all the time. Regulators, on the other hand, can catch them.

If you say to a financial institution that proprietary trading is not an accepted practice, any well-managed financial institution knows how to run its business in such a way as not to be engaged in proprietary trading. And people who argue that you cannot find this out have not in fact run these institutions.

Chairman DODD. Mr. Johnson.

Mr. JOHNSON. Senator, I tend to agree with you completely on this question. You can. Within the banks, if the executives decide to shut down proprietary trading, they can do it. Sandy Weil, if I am not mistaken, closed the proprietary desk of Solomon Smith Barney in 1998 because he did not like the positions and the losses that they had incurred.

But to come in from the outside and to say to legislators, or have regulators say, no more proprietary trading would I think lead to exactly the kind of evasion, evasive tactics you are talking about because there are many other ways to construct the same sort of risk return profile, which is what really they are going for with proprietary trading.

They will not call it proprietary trading. It can be disbursed. It can be put in different ways. So I agree with John Reed, that if the management really wants to do this, they will do it.

But to impose it from the outside I think would be illusory at best and could lead to all kinds of dangerous distortions.

Chairman DODD. Gerry, in asking you to respond to the same question, tell us here what the impact would be on Goldman in terms of revenue and profits. Would it put a prohibition on hedge fund activity, private equity activity? As a practical matter, what happens at Goldman if we have an ironclad rule?

Mr. CORRIGAN. The answer is not as much as some people tend to think.

I think it is theoretically possible, Mr. Chairman, to construct a very tight regime for a very, very limited class of activities that you could call proprietary trading, where there is absolutely no interaction whatsoever between a group of proprietary traders and clients, and that activity is totally walled off within a given institution. But that would be a situation which I think would provide some liquidity to markets and price discovery, and that is fine.

But to take the Goldman Sachs situation, if you took the net revenues associated with the best I can do to imagine a sensible definition, for example, of proprietary trading and hedge funds and private equity funds, we are, in net revenue terms, talking about something over the cycle in the broad order of magnitude of 10 percent of firmwide net revenues.

Now I say over the cycle because in good years it could be a little higher, in bad years a little lower. But if you want a reference point, at least using Goldman Sachs as the example, that I think is as good as I can do right now since I do not know what the definitions that other people would have in mind when they talk about these alternative schemes.

Chairman DODD. Let me ask. Paul Volcker said he used, I believe it was Potter Stewart in his definition of pornography: You know it when you see it.

I am hesitant to go down this road, but nonetheless since he used Paul Volcker talk, which gets to the point in a sense that Professor Johnson and John Reed were making, that if it is the bank institution looking at it, and they know it when they see it, that is one thing. When the regulator is looking at it, you could end up with two different people with a very different analysis of whether or not something is pornography. So the lack of clarity and the lack of certainty seem to be affected.

So I have to look at this from the standpoint of not only the institution, what the effect is on the institution and the risk posed by it, but can you define it in a clear enough way so that a good regulator would be able to identify it and see it and respond do it. And that is really the prism I think through which we have to look at this—not to exclude how the institution looks at it, but more importantly I see it as how the regulator would look at it.

Do you agree with that? And, if so, then I pose the question again. Can you do this?

Mr. ZUBROW. Mr. Chairman—

Chairman DODD. And put it this way, I really do not like it. But could you do it?

Mr. ZUBROW. I do think it is also important to remember that Justice Potter Stewart's remark also went on to say, with respect to pornography, that this is not it. And I think Mr. Volcker is also having the difficulty in saying that it is a very simple definition and it is very easy to see, but he seems to be having difficulty coming up with what that pure definition should be.

I think that one of the significant issues that the Committee should is that proprietary trading not only means different things to different people, but in different contexts can mean different things. So, for instance, we obviously, in our regular market-making activities and client-facing activities, often take on positions from clients. We then need to hedge those risks. Now is that proprietary trading?

Those risks have been given to us. They came out of client market-making activities, but now they are the bank's risks. So, if we want to go out and hedge those risks prior to being able to flatten those positions, that obviously could be interpreted by some as a form of proprietary trading.

I would agree with Gerry's comment—if you take the extremely narrow definition and say that you put a group of traders in walled-off area, give them an amount of capital. That is not a business that we are in. That is not something that we find strategically attractive. Obviously, if we were to eliminate that type of activity, that would not have a particular impact on the firm.

Chairman DODD. Thank you.

I have gone over my time, and I apologize to my colleagues. Senator Shelby.

Senator SHELBY. Mr. Corrigan, under existing authorities today, regulators are able to ensure the safety and soundness of an institution. I think that underlies everything here.

Do you believe that regulators presently have the ability to restrict a firm's activities, including their proprietary trading, if they deem this not to be a safe and sound practice?

Mr. CORRIGAN. I do not think there is any question at all, Senator, that they have the authorities. That is a no-brainer.

One of the principles—

Senator SHELBY. If they have the authority, then it is a question of do they have the will to use their authority. Is that right?

Mr. CORRIGAN. That is precisely the point, Senator. One of the principles that I articulated in the statement that I gave you is that going forward the official community has to conduct its affairs in such a way that what we call prompt corrective action becomes

a reality rather than a slogan, and that I think is one of the great challenges that we face in the context of this whole effort of regulatory reform. I do think there have been some cases in the past where this notion of prompt corrective action works, but I think in the future we need to make it work better.

Two elements, Senator, that go into that are a much, much more aggressive framework of stress testing. One of my favorite inventions that Mr. Zubrow knows about, reverse stress tests and extreme contingency analysis have to play a much bigger role in the future than they have in the past. If we can do that appropriately, which I think we can, I think that that is one of the absolute prerequisites for making resolution authority work.

Senator SHELBY. Speaking of that, Mr. Zubrow, Senator Corker and Senator Warner on this Committee have spent a lot of time on how do we find resolution authority here in our hopeful legislation, piece of legislation. If we basically all agree—and I hope we do—that nothing is too big to fail, and if we have sound regulation, the power, that regulators have the tools to regulate and do their job, safety and soundness trumps.

What are a couple of things that you would suggest, and they may have covered already, these two Senators, in any resolution authority that would be deemed so important?

Mr. ZUBROW. Well, thank you very much, Senator for that question, and I agree with you. I think Senator Warner and Senator Corker are doing a terrific job leading the effort to really focus on what we mean by resolution authority.

Senator SHELBY. Absolutely.

Mr. ZUBROW. And I think that, first and foremost, it is very important that there be a clear regime in which firms can be allowed to fail. And part of that is obviously a recognition that when a firm gets into trouble, that they managements of those firms should be eliminated, the shareholders should be wiped out, and the creditors should be able to be dealt with through the existing regimes of the bankruptcy laws.

Senator SHELBY. Hopefully, the taxpayer will not have to step up, right?

Mr. ZUBROW. Absolutely. And if you eliminate the shareholders' equity, if you have the ability to eliminate unsecured debt to the extent that is needed, then obviously there should be more than enough resources in those circumstances, so that the taxpayers do not have to be involved in any way in a bailout of those firms.

I think it is also very important that large, complex firms be prepared with their regulators for that potential eventuality. We have already begun discussions with our lead regulator, the Fed, about how would we think about how a regulator would step in, in a resolution regime, because I think it is very important that the regulator as well as the firms themselves think about the various steps that might happen under that situation.

Senator SHELBY. Is it in your mind very, very important that any legislation dealing with resolution authority be unambiguous that nothing is too big to fail, and if it bellies up we are going to close it down?

Mr. ZUBROW. I think that it is absolutely critical that that be clear in the legislation.

Senator SHELBY. Professor Johnson, you have a comment?

Mr. JOHNSON. If I may, Senator, in the whole discussion of resolution authority, if I could just speak from the perspective of my previous job at the International Monetary Fund, that the hottest issue is the cross-border resolution. I think all the firms that are represented here and most of them sitting behind me are cross-border firms with massive, complicated international pressures. One thing we learned from the failure of Lehman is that regulators have just different statutory frameworks. There is a massive conflict over that.

And the only way around that, at least on an interim basis, is to have a conservatorship, which is not exactly failing. That is the Government putting in money into AIG type situation. Unless you have cross-border authority—

Senator SHELBY. That is what these two Senators I mentioned have in mind, but they can speak for themselves.

Mr. JOHNSON. My basic point from the perspective of the IMF, I would suggest, is that unless you have a cross-border resolution authority, which even the Europeans have struggled to establish within Europe, let alone U.S. to Europe, let alone U.S. to emerging markets, any resolution authority based just on the U.S. is not going to achieve the goals that you quite rightly are emphasizing.

Senator SHELBY. Professor Scott.

Mr. SCOTT. To come back to what the “too big to fail” problem is, I think it is the degree of interconnectedness. So what you have to ask yourself, in addressing your question, is: Will we have the insolvency of a large institution which we have to rescue because it is too interconnected to let it fail? That might not be affected by the size of the total institution. It is a function of its positions with other parties.

So, in answering the question, should a resolution authority not be permitted to bail out an institution, I think it would have to have a very high degree of confidence that you would not have a situation in which an institution failed that was highly interconnected because if you did not bail it out, then you risk a chain reaction of failures.

So I think it is really important to understand the degree of interconnectedness of our institutions, and I think we have done a woeful job at uncovering that and that a lot more attention needs to be focused on what these connections are. For instance, I think we thought when AIG was rescued that it had to do with their counterparty positions. But then we are told by some of their counterparties, one of whom is sitting at this table, that they were totally protected in the event of an AIG failure.

And I am not questioning that, but what I am questioning or asking is if you are going to design a resolution authority that says we will never rescue an institution, you have to have a high degree of confidence that you will never be in a position where these large connected positions could create a chain reaction of failures if you did not rescue the institution.

Senator SHELBY. Mr. Reed, do you believe that regulators lacked necessary authority and power to rein in reckless activities or do you think that regulators simply failed to use their available tools?

And do you believe that regulators have been held accountable for their failure?

Mr. REED. Well, I agree with Gerry, the regulators clearly have the authority to rein in any practice. They have failed to do so for the human reason that they get captured and caught up with the current wisdom. It is very difficult to organize a structure that can systematically have a contrary view and divorce itself from current wisdom.

The regulators have the authority. It is rare indeed that the regulators have anticipated and stopped problems.

I do not think many people at all have been held accountable for what is going on. The regulators certainly have not been held accountable nor necessarily have the managements and boards of some of the financial institutions involved—so, in terms of who has been held accountable, not many.

Can we rely solely on regulation, I do not believe so. You certainly need regulation. You need the right regulation. And you need a strong regulatory structure, but it is not in itself, I believe, sufficient.

Senator SHELBY. You got to have good management.

Mr. REED. And that is why I like this compartmentalization.

Everybody is playing around with what is proprietary trading. That, with due respect, if you are running a company, you know if you are in the business or not. You do not hire the kind of people who want to be in that kind of business if you are not supposed to be in it.

I believe that the nature, the human makeup of an institution is extremely important, and that is why I tend to favor Mr. Volcker's thought on regulating some of these types of activities that bring in a different kind of culture to big depository institutions.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman DODD. Thank you.

Senator JOHNSON.

Mr. Reed, would the Volcker Rules be difficult to implement? What challenges would it pose to the regulators?

Mr. REED. Senator, I don't think they would be difficult to implement and I don't think it would be a regulatory issue. I think it would be a management issue. In other words, if there were rules with regard to the nature of businesses that certain entities could be engaged in, you could count on most good management to try to follow those rules. Regulators might well debate with the management whether certain practices are, in fact, OK or not. But those kind of debates are quite healthy and the regulators, if they insist, have the authority to have their views hold.

When I was in the banking business, there were any number of activities that were not permitted of the banks that I was responsible for running at the time. We never had any problem knowing where the rules were and we didn't specialize in trying to get around the rules. The regulators are quite able to spot when a management is behaving differently than the rules call for and they certainly have the capacity to stop it. So I don't believe this is a real issue.

Senator JOHNSON. Professor Scott, there are concerns that allowing commercial banks to engage in proprietary trading activities unrelated to serving customers creates unmanageable conflicts of interest. Can you provide some examples of these conflicts of interest in our marketplace?

Mr. SCOTT. Not in the actual marketplace, Senator, but I think I could talk about the hypothetical marketplace.

Senator JOHNSON. Yes.

Mr. SCOTT. And I could see a situation in which a customer's interest was adverse to the interest of a proprietary trader. The customer would have a position that the trader was taking the opposite side of. It could hurt the customer's position. Now, my understanding is, of course, that these activities are walled off and that the proprietary trading desk is totally separate from the people who would be dealing with the customers and that that really handles the situation.

I should say that commercial banking is full of potential conflicts. This is not the only conflict. And indeed, in the debate over Glass-Steagall, the emphasis was not on this. It was actually on underwriting, which nobody is attacking here, and the thought was that banks who took positions in underwriting, were potentially exposed to risk on underwriting, would not act in the interest of their customers and force them to buy something in order to protect the bank from risk. Again, we handled that situation by trying to isolate activities within the organization.

So I don't think—if you are really worried about conflicts, this is a much bigger issue, and I wouldn't start with proprietary trading if I were worried about it.

Senator JOHNSON. Mr. Zubrow, at Tuesday's hearing with Chairman Volcker and Secretary Wolin, there was much discussion about how to define proprietary trading. In your testimony, you echo those concerns. If you were trying to prevent or stop the riskiest types of proprietary trading activities at commercial banks, how would you define proprietary trading?

Mr. ZUBROW. Thank you, Senator. As I said, I think that it is very important to make sure that banks are able to continue to trade in ways that will allow them to hedge exposures that they take on. And so if I were to come up with a definition that was trying to wall off something that was pure proprietary trading, it would be utilizing the definition of taking a group of traders, putting them into a separate area, having the firm invest capital in that, and have that group not be engaged at all in any client or market making or other activities other than just trading of that particular capital.

I do think, as I said before, that it is very important that firms like ours have the ability to continue to manage the various risks that we take on in our client-facing businesses and to not allow some broad definition to be enacted that would limit our ability to properly manage those risks.

Senator JOHNSON. Professor Johnson, some preliminary analysis of the Volcker Rules contend that this proposal could have profound effects on the profits and business models of large U.S. financial firms, particularly those whose proprietary trading functions

are fully integrated into the firm's global business. Do you agree with this statement?

Mr. JOHNSON. Senator, the evidence that I have seen suggests it would have a relatively small impact on the profitability of these banks, with the possible exception of Goldman Sachs, as Mr. Corrigan emphasized. That 10 percent over the cycle of net revenues is probably an outlier for a bank holding company, and, of course, there is discussion about whether people who have bank licenses would be allowed to hand those licenses back and go off and become some independent structure not regulated by the Federal Reserve.

If that were to be the outcome of the Volcker Rule, if that were permitted by the rules that you draw up and how they are implemented, that would be a complete disaster, because you can't have a situation where banks are very big doing banking activities not subject to comprehensive, tough regulation, which is, I hope, what we will get out of the regulatory structure that you create. You can't just go off and take those massive risks and then when you face a collapse say, oh, I would like my banking license back. And Goldman Sachs, I think, got a one-time-only pass—I hope—when they were allowed to go to bank holding company in September 2009—2008.

Senator JOHNSON. My time has expired.

Chairman DODD. Senator Corker.

Senator CORKER. Mr. Chairman, thank you, and thank all of you for your testimony. I think the Volcker Rule is—I think the goal of it is one that all of us would like to achieve, and that is figuring out a way that institutions are not too big to fail. I think the abstract nature of it made it difficult.

I want to agree with our Ranking Member. I think there is a lot of regulation in place, if regulators will just do what they are supposed to do to keep much of what has happened from happening. And I do think there ends up being a capturing of those regulatory. They are embedded in your institutions. They get to know you. They are having coffee with you every day. They are going to lunch. And the next thing you know, things happen. So I hope we can figure out a way to keep that from happening in the future.

But Mr. Corrigan, I understand that in many ways, if the Volcker-like Rule was put in place, Goldman would be the Br'er Rabbit of this whole deal, that you drop your holding company situation and have less competition. I wonder if you might respond to that.

Mr. CORRIGAN. Well, first of all, it is not entirely clear to me that that would be the result, but let me come back to that in a minute.

Under the House bill, and I hope that under the Senate bill and the ultimate legislation, we would have a regime in which any systemically important institution would still be subject to consolidated supervision, presumably by the Fed.

Senator CORKER. Now, you are answering a question I didn't ask, so since it is my time, I am going to—so you can either go right to that question—

Mr. CORRIGAN. But that is the starting point for your question.

Senator CORKER. OK.

Mr. CORRIGAN. So whether Goldman Sachs continued to be a bank holding company or not, it would still be subject to consolidated prudential supervision. I think that is the way it should be.

Senator CORKER. I was struck by your testimony regarding all institutions, that no institutions should be too big to fail, and then your solution was that if a company failed, they would go into temporary conservatorship. That is not much of a failure. So I am shocked by that and I wonder—

Mr. CORRIGAN. Well, let me—

Senator CORKER. —I think what we have all been talking about is that if you fail, you don't exist anymore and a temporary conservatorship is much like what we have just gone through.

Mr. CORRIGAN. Well, let me define terms a little bit better here, if I may. First of all, when I talk about temporary conservatorship, I have in mind that this feature of the process would exist only for a very short period of time, a matter of days or weeks. And I am not sure that conservatorship technically is the right legal word. But what I feel very strongly about is that we need to have a limited period of time after the institution in question has been taken over by the authorities—the shareholders are out, the managers are out, the board is out—we need a limited period of time to be able to put ourselves in a position where we can, in fact, execute a prompt, timely, orderly wind-down of an institution.

Senator CORKER. Or receivership.

Mr. CORRIGAN. That is correct.

Senator CORKER. Let me move on. I appreciate very much your testimony. I would say that even under the Volcker Rule, if you had consolidated supervision but didn't have a bank holding company status, you would not be under the Volcker Rule. So consolidated supervision is not what is relevant.

But let me move to Mr. Reed. I found your comments interesting, and certainly I respect each of you very, very much, as I do Mr. Volcker. But the comments about separating these, you were Chairman of Citigroup when all of this was put together. I think that is fascinating for all of us to know that you kind of put all this together and now are an advocate of separating, and I just wondered what you might share that you have learned since that time.

And I would add another question, since I may run out of time. A lot of people think that Citigroup is one of those organizations—and I was watching the body language when we were talking about failure—that Citigroup is one of these companies, because of payment mechanisms that exist around the world with sovereign governments and others, that Citigroup cannot fail, OK, that they are so interconnected. And I think what all of us are seeking, even Chairman Volcker and others, is figuring out a way that regardless of the interconnectedness, there never will exist again in our country a financial institution that is too big to fail. We don't like that moral hazard. It goes against the American way.

And yet there are people who come in, I think, and believe that a Citigroup, I am sorry, they are so interconnected, they have payment systems, and I wonder if guys like you and others laugh at us when we say that we want to create a regime that absolutely ends forever in the American vocabulary that any company is too big to fail. I think that is the goal of many people on this Com-

mittee, maybe not everybody, but I think many people. And I ask everything I have just asked with respect. I do find it fascinating, your position.

And then, second, I wish you would respond to the issue of “too big to fail.”

Mr. REED. Senator, I learned a lot. There is no question that when we put Travelers and Citi together, we created a monster, and most of the difficulties we have had have stemmed from the Salomon Brothers side. Salomon had just been recently acquired by Travelers, but this is why I am so sensitive to the cultural impact.

I am suggesting that it would be healthier for the system—it may not be healthier for Citi’s stockholders, but I am retired. I am free to speak as an individual citizen—

Senator CORKER. It is kind of like a Senator who is not running again.

Mr. REED. That is right.

[Laughter.]

Mr. REED. So my honest belief, having experienced it and having lived with it for years, is that the system would be stronger if we could provide for some separation where major depositories are not major actors in the capital markets. And you will notice that as I made my comments about these cultures, I didn’t talk only about proprietary trading and proprietary investing. I talk about this interface with the capital markets.

I believe that it is very difficult to manage these cultures. It is not impossible, but it is very difficult. They are hard to contain. They have big impacts on the risk taking sort of attitudes at the top of the company and the nature of the people who are working in the company. I think the system would be sounder if we had a couple major institutions that were a little pedestrian and that weren’t occupied by all my colleagues from MIT who are pretty good at math.

So I have come to the conclusion, having lived it, that the system would be better if we allowed for some compartmentalization. And as I said in my testimony, as I said in my written remarks, I would look at compartmentalization of culture as much as of economic function because it is the people within the company.

So I have learned from my experience, and I think probably there wasn’t a much more relevant experience around, and my conclusion is the system would be better. I am not speaking for the stockholders. The system would be better if we allowed for the type of separation that Mr. Volcker is talking about, and I think he probably comes at it from the same point of view. I saw him recently and he said, “John, it is the first time you and I have ever agreed, isn’t it,” because we have had a number of issues where we didn’t. But I think he saw it from the same point of view.

Too big to fail, Senator, I am totally on your side. We have to come up with a mechanism that, regardless of the particular interconnectedness—Gerry is correct, we may need time to get this organized, but you have to be able to let institutions fail and I think you have to wipe the stockholders out. I think you have to wipe the board and the management out. And we have to have that mechanism.

And it is true that Citi, in its current structure, would be very difficult to unwind, and the global issue would come up right away. And this global issue is real. There is no question. I forget the name of the British institution that failed in Singapore—Barings failed in Singapore. The Bank of England could not control the unwinding of this because the Singaporean authorities got into the middle of it and you had this cross-legal jurisdiction problem.

So I do think Professor Johnson is correct in that regard, but I am on your side totally that we must come up with an architecture that allows us to say any person that gets in big trouble must be permitted to fail, and the bias has to be in that direction.

The question, Senator, why did we save Long-Term Capital? It was alone. It could have been allowed to fail. But the instinct of regulators is to organize a rescue mission. And so I think you need a structure that sort of dampens that instinct.

Senator CORKER. I would love to hear from everybody, and I don't want to be rude to my colleagues by asking another question, but I do hope in another setting we can, on the phone or by e-mail, talk more about the interconnectedness Professor Scott and many of you have brought up. I thank each of you for your testimony and I do hope we figure out a way to deal with the interconnectedness in a way that, through legislation or some other mechanism, regulation, that allows big companies to fail.

I just want to say, it seems like every crisis we have had since I have been alive, and I am 57, has centered on real estate—just about—and somehow or another we still don't talk about that and we talk about all these other things, but that is a subject for another day.

Thank you, Mr. Chairman. Thank you for your testimony.

Chairman DODD. Thank you, and let me just say again, I said at the outset in my remarks, having now just chaired this Committee in my third year, since January of 2007, the tremendous talent on this Committee. This is a hard subject matter and all of you have spent your lives involved in this. None of us claim to have lifetime experiences in all of these matters, but we have had tremendous contributions from Bob Corker and Mark Warner, Jack Reed, so many people on this Committee, delving into the various aspects of this, and it is hard work. It is difficult work.

It is arcane work, in many ways, and we are all very sensitive to the notion that every good idea has an unintended consequence and trying to think through all the ripple effects of what you are suggesting. At one level, it can seem like the best idea in the world. And as you delve into it—I said the other day on these matters, I kind of regret we are not back 5 or 6 years ago when we knew a lot less about all of this than we have learned. It was easier when you knew less in terms of the answers for things. So I thank the Senator from Tennessee. He has been tremendously valuable on this Committee, along with others.

Senator Reed.

Senator REED. Thank you, Mr. Chairman.

Mr. Reed, I have been struck by what you have learned. I think we have learned something, too, and I think we have to carry it into the formulation of new regulations. First, we can't assume regulatory capacity adequate to the complexity of the financial mar-

kets. That is a function of funding and appropriations. It is a function of ideology. It is a function of personalities. But many of the discussions that we have heard, I think assume that, and I think that is an assumption that we have to question.

The other aspect of this is managerial capacity, as you point out in your comments on culture. This would have been a different world if there had been different individuals at different institutions, but they were there. And I think also, too, in terms of who rises to the top of these complex institutions is a function not sometimes of who they are but what they do and how much money they make for the company. So I sense all of that.

I think in that regard Chairman Volcker has raised the right sort of issue, but I think perhaps we have sort of taken the wrong path and we are now talking about proprietary trading and how to define it, *et cetera*. I think your approach is much more, I think, on target, which is what do we want? We want financial institutions, commercial banks, who focus on serving customers, who are businesses, consumers, basically, and we want them to be their core competency, *et cetera*.

So one way to look at this is to say rather than you can't do proprietary trading, is that if your core business is just a fraction of what you do, then why should we allow you to get to the discount window? Why should we include you in Section 13(3)? That is not our policy. Our policy is to support a vigorous commercial banking system. What about that approach, Mr. Reed?

Mr. REED. Senator, I agree with you. I think what we are striving is to have a healthy commercial banking sector. I think it is very important that there be a Goldman Sachs in the world and so forth and so on, and no one is suggesting that these activities be prohibited, simply that they not be in these big depository institutions.

Commercial banks used to focus on customers and basically provide working capital finance. And if you needed to get into exotic instruments and so forth, the commercial banks didn't do that.

I think the recent crisis through which we are stumbling would have been much different had there been three or four large depository institutions that weren't in the center of it. I think one reason why JPMorgan Chase was able to play a positive role is that they did not have in the core of their business these kind of activities. They had some problem activities in terms of sourcing mortgages from third parties and so forth, but they played a positive role. The Bank of America, which absorbed Merrill Lynch, had the capacity because they didn't have these kind of problems. I think it served the country well to have some of these institutions that were not tainted by these kind of activities.

But I don't think the solution is to now say we will let everybody do everything. I think we want our big depository institutions to focus on serving their customers, providing working capital, finance, deposits, consumer, and so forth.

Mr. REED. Mr. Johnson.

Mr. JOHNSON. If I could just add to that, Goldman Sachs in 1997 was about a \$200 billion bank in terms of assets. It was about \$270 billion in today's money. It peaked at about \$1.1 trillion. Now, I completely agree with Mr. Reed that having risk takers and risk-

taking institutions in our economy is useful. I am a professor of entrepreneurship at MIT. I am completely supporting that. But if you let these risky enterprises become big relative to the system, when a crisis comes, even if you have a relatively stable core—and I do fully endorse what Mr. Reed is calling for here—you have this rather stable core and you have got very big other parts of the financial system that fail or are in danger of failing, then you let them into the discount window, which is what we did in September of 2008. So the size of these risk-taking parts matters, even if we are able to achieve a stable base, which is what Mr. Reed is rightly arguing for.

Mr. REED. Mr. Corrigan, I think you need to have a chance. You should turn on your microphone, because we want to hear this.

Mr. CORRIGAN. Today, the balance sheet side at Goldman Sachs is something in roughly \$800 million-plus or something like that, so it has contracted in size relative to what it was a few years ago. But I would also observe that at least half, and perhaps more than half of the growth in Goldman Sachs over the past 10 or 12 years has been international, not in the United States but around the world, and I think that is an important factor, as well.

But I really want to focus on these comments about discount windows and discount rates. I completely agree with what John Reed said a few minutes ago about discount window and discount rates. And as I am sure your staffs will note, in my statement—

Senator REED. I noted it directly.

Mr. CORRIGAN. —I had two things to say about discount window. One was that as the Fed winds down its heavy crisis intervention, in my judgment, we should go back to the old-days regime of the discount window, and under that old regime, even if you were a bank holding company, the bank itself had access to the discount window, but under the old rules, the bank could not take funds that it got through the discount window and cross-stream them to nonbank affiliates or to the holding company. Once we get this crisis behind us, that is what we should go back to.

In addition to that, in my statement, I was very clear in saying that going forward, we need to modify the so-called “13(3) rules” as they apply to the extreme emergency situations using the discount window, and what I personally have in mind is something along the lines of what I think is in the House bill, and I think, Senator Dodd, I think you have been contemplating this, as well, is that at a minimum, to use 13(3) under any set of circumstances, the Federal Reserve would have to get the consent of the Treasury.

So I am not by a long shot even close to a point of view about the discount window that is anything other than extremely conservative, both for so-called “regular use” of the discount window and emergency use. I think that, again, the traditional roles that said a bank in a bank holding company has access to the discount window, that is where we should get back to.

Senator REED. My time has expired, but I just raise the question—I think like Senator Corker, this will be an ongoing dialogue, but the crisis that we saw last year, getting the permission of the Secretary of Treasury to use 13(3) would not be too hard, because I would suspect he was begging the Federal Reserve to use 13(3). So we have to—and that, I think, is the ultimate. When we talk

about “too big to fail,” we are basically saying there are some institutions that don’t get 13(3). I mean, that is when you cut it to the core.

Mr. CORRIGAN. I agree with you on that, too, Senator Reed, but if I could, I would like to go back to this interconnectedness question and “too big to fail” and resolution authority, because I am convinced, absolutely convinced, that we have to get this resolution authority right. And in my statement, for example, I have laid out a bill of particulars that take the form of prerequisites that have to be in place for every large integrated financial intermediary that would make it possible for resolution authority to work the right way. Every one of these particulars deals in very specific terms with interconnectedness.

I don’t want to sound like—but I think that over the years, I probably have thought more about interconnectedness and the plumbing of the financial system, as I like to call it, than most everybody. But I think it is urgently important that the regulators, working with the major institutions, have to focus on these prerequisites, because I will tell you that in my judgment, if we don’t get that right, we will not be able to close down “too big to fail.”

Senator REED. My time has expired. I thank my colleagues for indulging.

Chairman DODD. Thank you, Jack.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you all for testifying today on these issues that are so important to our future economic health.

Mr. Reed, you noted the question as to why do we rescue Long-Term Capital Management, and you noted that it stood alone, and I think you said, but there is an instinct in the system to save a major player. I want to turn back to that example to pursue that a little bit further.

This was at the end of the 1990s and there were a lot of investments by major financial houses in Russian derivatives. If I recall right, Long-Term Capital Management, had it gone under, it would have been selling at fire sale prices. Many of these investments, which I believe we also had a number of large financial houses deeply invested in, including, I believe, Goldman and JPMorgan both had positions that were at risk, and so these other entities came together to help bail out Long-Term Capital Management to avoid at that point interconnections that were driven by market considerations. That is, one piece of the interconnectedness, if one firm fails and has to sell at fire sale prices, it drives down everybody else’s asset portfolios. That is another form of interconnectedness or risk in the system.

So could those of you who were involved in this or who have studied it share just a little bit more about the lessons to be learned from that setting, that form of risk, how that can be addressed? And it also certainly came up in mortgage-backed securities, the potential for them to be sold, and so forth.

Mr. REED. Well, Senator, I think you are absolutely correct as to what drove the rescue, that people felt that it was easier to rescue than to allow it to go broke. But this is why people are going to be very reluctant ever to say we are going to allow a given com-

pany to basically go bankrupt, because there is this level of interconnectedness.

The lesson we should have derived from that is we didn't have enough capital. There wasn't enough capital in the system to take the risks that were there. And we didn't learn that. Had we learned that with Long-Term—

Senator MERKLEY. Are you speaking of the issue of leverage? I remember at one point—

Mr. REED. There was a tremendous amount of leverage.

Senator MERKLEY. —101 or something like that.

Senator REED. Yes, it was tremendous leverage, and what we should have learned was that there wasn't enough capital to absorb the risks that were in the system, and therefore, when the risks manifest themselves, the human reaction is, let us gang together and we will see if we can take this together. Well, we had a situation there that was a one-institution version of what later happened to all of us and where basically the taxpayer had to step in because there wasn't enough capital in the private sector to cover the risks that were manifesting themselves in this crisis we have gone through.

And so my question about Long-Term Capital was there was the anatomy of the problem that we are today wrestling with. It was alone that sat there. It was tremendously interconnected. As you say, it had counterparty lines. It had all sorts of assets which conceivably would have been liquidated at very distressed prices and so forth, which would have impacted the market. And yet as a system, we sort of ganged together, papered it over, and went on having learned nothing.

Mr. ZUBROW. Senator?

Senator MERKLEY. Yes, Mr. Zubrow?

Mr. ZUBROW. Senator, if I could just add one point, which is that I also think that that is an example of how we allowed fundamental regulatory arbitrage to lead to a very difficult situation. And obviously, Long-Term Capital was outside of the regulatory regime. It wasn't subject to the same capital requirements or oversight as other institutions. And so I think that one of the lessons that we learned from that is that all firms that are systemically important need to come under the same umbrella of regulation, the same capital regimes, and the same oversight of regulators and not allow the form of ownership or the type of business they are in to allow those institutions to escape that type of comprehensive regulation.

I would just comment that I, frankly, was somewhat surprised in Secretary Wolin's testimony last week, or on Tuesday, that he suggested that we could sort of allow certain institutions to be able to escape the regulatory situation if they were to divest their banks, and I think that it is very important that in that situation, all organizations that are systemically important be treated the same.

Senator MERKLEY. I will ask both of you to be brief, because I am down to less than a minute. Mr. Scott.

Mr. SCOTT. I think addressing Long-Term Capital Management, the first issue is protecting the institution from failing, capital. But then we come to, well, maybe we will not succeed at that, it is fail-

ing. Now we have to deal with interconnectedness. We have done all we can, it wasn't enough.

If you look at the present world of interconnectedness, it is not about equity. Equity is not an interconnectedness problem. I do not think it is about debt. I do not think that we are worried particularly from an interconnected point of view who is holding the bank debt. We may have other issues about that. It is really counterparty. It is really derivatives, in my view. And the answer to this is clearinghouses.

If you go back to the years when Mr. Corrigan was serving very adequately in the Federal Reserve Bank of New York, his major concern was the payment system, and particularly the clearinghouse interbank payment system, because if there was a default, you would have a systematic chain reaction of failures.

What did we do about that? Well, we managed to figure out a way that that thing could function without causing that problem. It now settles continuously. You do not have end of the day large net positions that could endanger the system if there is a settlement failure.

So we have to address the same problem now in the context of derivatives. And I think that needs to be the focus here, because that is, in my view, the interconnectedness problem today.

Senator MERKLEY. I am over my time. Shall I allow Mr. Johnson to respond, as well?

Chairman DODD. Sure.

Mr. JOHNSON. I am afraid we haven't learned the lesson of LTCM, which is the capital that needs to be held with regard to derivative positions is still far too low. And that is where the regulatory arbitrage exists and it is still engaged in on a massive basis every day by the firms represented on this panel. We have not learned that lesson.

In my written testimony, we have a very specific proposal about how you can change those capital requirements. But I think it is going to be hard to do because you are going to be fought every inch of the way by the people who make a lot of money on this regulatory arbitrage.

Senator MERKLEY. Thank you.

Chairman DODD. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Let me thank all of our witnesses.

As I approach this issue, I look at it as how do we strike the right balance, the appropriate regulations at the end of the day to make sure we don't have another taxpayer bailout, and at the same time the opportunity to make sure that growth can take place in our country.

But I have to be honest with you. I was reading through the written testimonies and I get a sense that while we take—it is like a Texas two-step. We claim the veneer of saying that we understand and need reform. And then we have so many caveats to it that we, in essence, undermine the very essence of reform. And that just—that dog simply is not going to hunt because if, in fact, we have what we had in the past, we are destined to relive it again.

And I hope the financial institutions, those that are here and others, understand that because they would be far better served in helping us strike the right balance on the pendulum than going ahead and just fighting us tooth and nail.

I have got to be honest with you, when I walk the streets of New Jersey, the average person comes up to me and says you know what? When I make a mistake, I have to pay for my mistake. And when they—meaning some of our financial institutions—make a mistake, I also have to pay for their mistake. Something is wrong with that, Senator.

And so I think sometimes my friends on the street have a disconnect with average Americans in this country, and it is a dangerous disconnect. It is a dangerous disconnect. I think everybody would be better served in honestly moving forward on this.

Let me ask you, Mr. Corrigan, I read your written statement and, you know, on page 10 you say that there is no question that the drive to shrink the size and activities of large and complex financial institutions is understandably driven by the political and public outrage about the use of taxpayer money to bail out institutions that were deemed too big to fail. And then you go on to say that because of that, observers believe that the easiest way to solve the problem is some combination of shrinking the size of these institutions and restricting their activities.

But it is really more than the public and political outrage. You are not dismissing the fact that there is a need to actually do something here?

Mr. CORRIGAN. Of course not, Senator.

Senator MENENDEZ. If you would put your microphone on, I would appreciate it.

Mr. CORRIGAN. I am sorry. Of course not, Senator.

Senator MENENDEZ. The statement seems sort of like dismissive, in my mind.

Mr. CORRIGAN. Then I did not do a very good job of drafting the statement, because if you look at the second section of that statement, it talks in very concrete detail of what I call the essential financial reform agenda going forward, and it is a line-by-line recitation of the things that I think must be done to get ourselves ahead of the curve for the next problem.

I talk, for example, about the need for substantial increases in both capital and liquidity, the need to look at capital and liquidity as a singular integrated discipline. I talk about the enhancements we need to the financial infrastructure. I talk about the improvements we need in supervision and regulation.

So again, if that is the interpretation, Senator, that you are drawing, I did not do a very good job of drafting that statement.

Senator MENENDEZ. Well, let me ask you, do you believe that there is any disconnect between entities like Goldman Sachs and the public at large?

Mr. CORRIGAN. Unfortunately, I would have to agree that there is.

Senator MENENDEZ. You know, I think part of that disconnect, when I look at that Goldman has set aside an astronomical sum of \$16.2 billion in compensation for 2009, that is 50 percent more than in 2008, and that is happening in a year in which the finan-

cial system nearly collapsed and Goldman Sachs received at least \$24 billion in taxpayer assistance, including \$14 billion from the bailout of AIG.

And so I look at that and I look at that in the juxtaposition of what Goldman is trying to do, which I think is laudable, but definitely underfunded in terms of your small business project, where you are basically going to put out maybe \$500 million, which is about 3 percent of the amount Goldman has allotted to compensation about 2 percent of the amount Goldman has received in taxpayer assistance, and I say, how is that being responsive to these times? Sixteen-billion dollars in compensation, \$500 million to lend to small businesses.

Mr. CORRIGAN. Well, let me respond to that on two levels. First of all, as I said before, I do agree with you that there, unfortunately, is a disconnect here. But having said that, I would just make a couple of observations.

First of all, I do think it is entirely accurate to say that the compensation framework at Goldman Sachs as it was amended further this year, I think is consistent to both the letter and the spirit of the various G-20 and other official guidelines on compensation. Now, that doesn't change the facts of the arithmetic, but I think that is a factually accurate statement.

With regard to your comment on our small business initiative, I guess, again, I would make two or three observations. First of all, if that initiative turns out to be as successful as the earlier initiative we did on 10,000 women, it will be quite successful.

Second, as that program begins to get legs, which is hopefully quite soon, I, for example, look forward personally myself, as being one of the mentors that will work with small business and small business leaders in the New York metropolitan area, and I am not suggesting you can put a price tag on that, but there will be hundreds, I suspect thousands of officials at Goldman Sachs that will be doing that as part of their personal contribution to the thing.

And the last point I would make, Senator, is that in the general area of providing financial support to medium-sized businesses and to some extent small businesses, Goldman, as you know, essentially is a wholesale firm. But the fact of the matter is that we are in the process of stepping up our programs and one of our business units aimed at both debt and equity support for small and medium-sized companies. We are in the process also of putting into place in the Goldman Sachs Bank, which is quite small, another program that is specifically targeted and directed at small and medium-sized businesses.

So it is not as if I think we are perfect. We are not. But I think we are sensitive to the very issues that you have raised.

Senator MENENDEZ. Mr. Chairman, if I just may, one last minute—

Chairman DODD. [Nodding head.]

Senator MENENDEZ. You know, I appreciate what you are saying, but the numbers belie it and this is my concern. The 22 banks that received the greatest amount of TARP funding have dropped their small business lending portfolio by \$10 billion over the past 6 months. So as I said, your goal at Goldman is desirable, but you are significantly, in my view, underfunding it, especially when I

look at the amount of money that is going to compensation. It is, like, 3 percent of that amount.

And last, you know, this disconnect—I know people don't want to hear about it, but for a while, it just seems to me that the industry would be best served—the *Times of London* reported that your CEO is likely to receive even more money this year than his record \$68 million a year. Is that true?

Mr. CORRIGAN. That is nonsense.

Senator MENENDEZ. OK.

Mr. CORRIGAN. Total and absolute nonsense.

Senator MENENDEZ. I am glad to hear that, because that is the type of challenge—I mean, \$68 million, I am happy for—

Mr. CORRIGAN. Trust me, it is not going to be that.

Senator MENENDEZ. —to be able to get \$68 million, but at the end of the day, if we see that type of reported increases—

Mr. CORRIGAN. It is not going to happen.

Senator MENENDEZ. —it just makes it very difficult—

Mr. CORRIGAN. It is not going to happen.

Senator MENENDEZ. —for people on Main Street to continue to understand why their taxpayer dollars should continue to fund institutions that, one, don't get it; two, fight financial reform; and three, ultimately have them holding the bag. And we need to change that if we want to strike the right balance here.

Thank you, Mr. Chairman.

Mr. CORRIGAN. Senator, please. Personally, I have a great deal of sympathy for everything you have just said.

Chairman DODD. Very good. As I said earlier, we have a vote that will be occurring shortly, so I am going to ask a couple of quick questions, then I will turn to Senator Shelby and Senator Corker. We will stay on as long as we can before we have to leave for the vote. I am not bringing people back.

Let me ask you to respond to—other Members to respond to what Professor Scott said earlier, and Senator Corker began that conversation, as well, and it is the interconnectedness issue, John, because I think we have wrestled with that in our conversations, as well. We clearly want—and there is a growing, I think almost unanimous consensus here, although I hesitate to say that until we actually get to the bill itself—but a consensus about the “too big to fail” notion. And I think, again, you have all expressed your views on it, as well.

Having said that, and in getting from Point A to Point B, where, again, the interconnectedness issue is not an irrelevant issue in today's economy and probably going to be a growing one in the global economic sense. So to what extent—what is the impact of that, potentially, on institutions' behavior? If we write in this matter here, what is likely to occur if we write this in a way that does make this about as, to use the word euthanasia that Paul Volcker used here, what are the implications of that for you?

You have all agreed with this, but what if what Professor Scott raised is accurate and, in fact, you face a situation where one institution should fail. No one questions that at all. What they have engaged in is clearly behavior of their own making, their own fault. Shut them down. Put them in receivership. But a lot of these other healthy companies out there, good companies, operating well, but

are connected with the failure of that institution. Is that a legitimate question Professor Scott raises, and if so, what are going to be the behavior changes that will occur institutionally, particularly in global markets? Gerry.

Mr. CORRIGAN. This is really, Mr. Chairman, the crux of the issue. Let me give you, again, an example or two of the kinds of things we can be doing to make it much easier to deal with interconnectedness when we find ourselves in the very situation that you have described, the next train wreck.

One example: Some institutions, certainly Goldman Sachs is one of them, have gone through—and I know about this because it was another one of my ideas—a very rigorous exercise that I call closeout stress test. It is very complicated. I am not going to bother you with the details. But what it is designed to do is to take hypothetical but very real world situations in which you say, just for the hell of it, let us assume that X and Y hit the tank. What do I do? How do I know what my exposures are? What do I do to manage those exposures? What approaches can I or can I not take in terms of closing out positions?

Now, I have been arguing—and Barry Zubrow can be my witness—I have been arguing for years that one of the basic standards that should apply to all large integrated financial intermediaries is that those institutions should be able in a matter of a couple of hours to put together counterparty exposures across—to particular counterparties across all products, across all locations, across all markets, both gross and net, and to do that within a couple of hours, because that is how you begin to get your arms around interconnectedness.

I, Barry, don't want to get myself too far out on a limb here, but I think I can probably say that the world is not full of institutions that even today can do that. Goldman Sachs can do that, and I suspect JPMorgan can do it, but I am not so sure how far that goes.

So that is, again, a very concrete example of the things that we can and must do to put ourselves in a position to better deal with the interconnectedness. This list of prerequisites that is on the last page of my statement for winding down and closeout is another.

So I am not ready to accept for 1 minute, and I don't think, Hal, you are, either, that we are hostage to a system that is so complicated that we can't deal with it. I just don't buy that. But I also say we have got a hell of a lot of work to do to get to that point.

Chairman DODD. Does anyone else want to comment on this? Mr. Johnson.

Mr. JOHNSON. I think Professor Scott made a very deep point with regard to LTCM, certainly. It is the surprise interconnectedness. Now, maybe we can measure these. Maybe the regulator will catch up, to some degree, with the technology. But you are always going to be surprised in a big crisis.

And then I think it comes down to two things. First, how big is this problem relative to the economy? Take CIT Group, for example, that failed last year. CIT Group had a balance sheet of \$80 billion. There was a big debate, as you know, in Washington about whether they were too big to fail, and it was decided, rightly, despite their interconnections that were known and unknown, that they could fail—and did fail, have essentially failed—without dis-

rupting the system. That is what we know. That is the biggest financial institution we have let fail and it hasn't had the systemic implications. Eighty-billion, that is what we know.

In addition to the size, it is about capital. It is about capital and derivative positions. I mean, that is the part that we know about, the part that Professor Scott and Mr. Reed have been emphasizing. These derivative positions with low capital requirements are asking for trouble. They are still there and they are not going away in the existing framework.

Chairman DODD. In fact, Barry raised the issue—I think it was he—do you see any deeper threats with banks that are creating over-the-counter derivatives, for instance. That kind of a matter poses some additional—when you start getting specific about the kind of proprietary trading that can occur, then you do begin to see some potential here for a larger question. Do you agree with that?

Mr. SCOTT. Well, I think a lot of the derivatives business is client-based, and so—and hedged—so I am not sure it is a problem. But I think Mr. Corrigan has raised a very good point. As part of our arsenal of weapons against interconnectedness, perhaps there should be a requirement that every large or important financial institution stress test itself, supervised by the regulators, so that they could survive a failure of their major counterparties. This would be basically what Goldman Sachs is doing. I think this is something that every financial institution should do and the regulators should require it.

Chairman DODD. Yes, go ahead, quickly.

Mr. JOHNSON. I have to ask the question, if Goldman Sachs is the gold standard of stress testing, why did they need to be rescued by being converted into a bank holding company in September of 2008? I don't understand. That is a disconnection.

Mr. CORRIGAN. That is a gross overstatement.

Mr. JOHNSON. Well, I am not sure if you had a chance to look at Mr. Paulson's book yet. I don't think he regards it as an overstatement.

Mr. CORRIGAN. Well, I mean, clearly, and Goldman Sachs and Morgan Stanley were made bank holding companies at the height of the crisis, and I think that turned out to be a very good thing. As I say in my statement—I was very clear about this—that we do benefit unquestionably from the intensity of the Federal Reserve's consolidated supervision of Goldman Sachs. But I don't think it follows from any or all of that that the mere fact—the mere fact of making Goldman Sachs a bank holding company constituted a bailout of Goldman Sachs. That is kind of pushing it.

Chairman DODD. Let me turn to Senator Shelby.

Senator SHELBY. A few observations. Professor Scott, on the Volcker Rule, in your judgment, the spirit of the Volcker Rule, I think, is a good idea. It is how you implement it and under what circumstances, how you do it, who would do it. Do regulators at the present time have the power to deal with that, or would we need to give the regulators some specific power outside of what they have, whoever winds up as the regulator—it might not be the Fed—and so forth. Do you have any documents?

Mr. SCOTT. I think they have the power as part of their general safety and soundness responsibility, and examining institutions, if they find—

Senator SHELBY. But they have got to have the will, haven't they? They have got to have the will.

Mr. SCOTT. Well, that is another question. You know, if I look at the Kanjorski Amendment, for instance, which is basically saying I want to give you this power, OK, to deal with large risks if banks are taking them, it is duplicating—

Senator SHELBY. They already have it, don't they?

Mr. SCOTT. —what powers are already there. But it is kind of underlining. Maybe there is a value to that, of just underlining the importance that the Congress sees in exercising that responsibility. But in terms of legally, yes, I think they have the power.

Senator SHELBY. And what about what Senator Dodd and Senator Corker have raised, and you have, too, on the panel, the problem of interconnectedness? That is in "too big to fail."

Mr. SCOTT. That is the absolute—

Senator SHELBY. Can the regulator deal with that now under the safety and soundness, in your judgment?

Mr. SCOTT. Yes. I think if a regulator believed today that an institution that they were supervising were not able to survive the failure of their significant counterparties, they could do something about it. Now, that being said, the ability to understand that—

Senator SHELBY. That is right.

Mr. SCOTT. —that is hard.

Senator SHELBY. Professor Johnson.

Mr. JOHNSON. I think that the evidence is very clear, that even the FDIC, which is actually pretty good, arguably even world class, at taking over relatively small- and medium-sized banks, even they come in too late. If the FDIC were doing its job properly, we would never need any taxpayer money. They would always come in while there was still enough capital left—

Senator SHELBY. Prevent it, in other words?

Mr. JOHNSON. Absolutely. Preventive action doesn't take place, even for the relatively less political ones. In terms of the point about the power and the caps here, let me remind you that under the Riegle-Neal Act, there is a cap on the size of our largest banks. That cap was waived every time the big banks asked for it. So JPMorgan Chase, Wells Fargo, and Bank of America all exceed the cap in that law, just because they asked for it. They were allowed to become bigger. So it is the same thing that would happen with all these other—

Senator SHELBY. And who waived it? The regulator. And who was the regulator? The Federal Reserve, right?

Mr. JOHNSON. Absolutely.

Senator SHELBY. OK. Now, as we wrestle with this, we all know, and you know because you spend your life in this as either a professor or consultant or a banker, it is very complex, and as Senator Dodd said, there always—when we raise a question, then it begets another one to deal with. But do you know—do any of you know of any institution, financial institution, that has been well capitalized—we talked about capital here earlier—well capitalized, well managed, Mr. Reed, and well regulated that has failed? Do you?

[Witnesses shaking heads.]

Senator SHELBY. I don't, either.

Thank you, Mr. Chairman.

Chairman DODD. Jack.

Senator REED. Well, thank you very much.

This issue of regulatory capacity, I think is important. Professor Scott, if someone called you up and said, the Fed is threatening me, shutting me down because they think my counterparties are unreliable, could you come up with some legal arguments why the Fed couldn't do that? Is it so clear they have that authority?

Mr. SCOTT. No, I would not say they could shut you down, but what I think they could do is tell you to change your business to get rid of that problem.

Senator REED. Are there any examples where the Fed has actually gone in and told people to change their business?

Mr. SCOTT. That happens every day to banks across the United States.

Senator REED. But apparently it didn't happen with respect to some critical issues.

Mr. Reed, you look like you want to say something. Do you have some experience with this?

Mr. REED. I am just smiling because you are absolutely correct. It didn't happen with—I don't think there are many examples where regulatory structures have been able to anticipate these kind of problems. You know, it didn't happen in Germany, which has a very different structure. It didn't happen in England, which has a quite different structure. And it didn't happen in this country.

Senator REED. I want to get to an issue that we have been spending some time on, and that is derivatives. One argument that end users are making is that this would deny them sort of a great financial benefit which would cause them to retract in many different ways. But, Mr. Reed, you ran a major financial institution which presumably did derivatives, end user derivatives?

Mr. REED. Yes, sir.

Senator REED. Did you, when your people were selling these, did you reserve the margin that you needed to cover the risk and did the ultimate end user pay for that margin, or—

Mr. REED. Yes. No, I mean, we put caps on the size of the business within the total company. You know, you run these businesses with caps, and this is why I think this argument that you don't know what you are doing just doesn't make any sense. If a trading room has a certain limit to take to have open positions, you know what those limits are. So we did have a derivative function and it was global. In other words, we operated in the derivative markets around the world. But we had limits with regard to positions. We had limits with regard to counterparties. And you run the business so, hopefully, it can't produce a massive problem for the institution.

Senator REED. This is a very lucrative business with banks, and at least one could argue that in either a clearing platform or a trading situation, that this would be much more cost effective for end users. But there seems to be this willingness to pay significantly for these credit default swaps, these over-the-counter devices. What is your sense on that, if I—

Mr. REED. Well, I think what happened is that they didn't attract much capital and so it appeared that you were able to significantly augment your earnings. I mean, what happened is the banks were basically using capital both for their customer business and for their trading businesses and they were doubling up on it. Obviously, this causes your return on capital to go way up.

I mean, the Deutsche Bank is a wonderful example. They announced publicly that they were going to get their return on capital up to 20 percent. Anybody who has done business in Germany knows that sort of a natural rate in the German market is maybe 7 or 8 percent. The only way they were able to do that was to build a significant trading and proprietary investing business on top of their banking business, and they did, in fact, achieve that result. They also ducked the great bulk of the problems that we are today confronting. They never did get any form of government assistance in Europe or elsewhere. So it can be done.

But the point is, the attractiveness of this kind of activity is that it hasn't brought capital with it and therefore you are basically doubling up and you are able to earn better returns for your stockholders.

Senator REED. Mr. Johnson.

Mr. JOHNSON. Senator, we also have to remember that the "too big to fail" is a form of implicit subsidy from the taxpayer, which lowers the cost of funding for these derivative transactions. So one reason the massive banks were able to dominate this market is because they are viewed by the credit markets themselves as too big to fail. That gives them an unfair advantage that enables them to scale up and create even more risk for the taxpayer.

The Bank of England financial stability people are calling this entire structure a "doom loop" because it is a repeated cycle of boom, bust, bailout, and we are just running through this again.

Senator REED. We have talked about interrelatedness, and I think that is a theme that everyone agrees to. But, Mr. Johnson, in terms of derivative trading, to what extent is that a key factor in this interrelatedness? I know there is no magic one thing, but it strikes me, given the notional size of derivative trading, given the fact that it inherently is staking your future to somebody else's future, would be one of the key drivers in some of these interrelated issues we have.

Mr. JOHNSON. Absolutely, Senator. So Mr. Corrigan said a little while ago that the total balance sheet of Goldman Sachs right now is about \$800 billion. But what is the balance sheet if you take into account derivative positions? That depends on risk models that they run that they report to other people. Perhaps the regulator has some independent ability to assess that. Perhaps the market has some ability to see through what they are doing. I actually don't think that they do.

So derivatives are very important because that is the complexity and it is where a lot of the interconnectedness today is manifested in problems that will always be there, and it is where a great deal of problems occur whenever there is a crisis. We just don't know what is the true balance sheet, what are the true risks, what is the true capital of these financial institutions without relying on their

own risk models, and those risk models failed dramatically and repeatedly in the run-up to September of 2008.

And with respect to Mr. Corrigan and the idea that Goldman Sachs was not saved by becoming a bank holding company, what would have happened to Goldman Sachs if it had not become a bank holding company, particularly based on its derivative exposure and what had happened in and around AIG?

Senator REED. You should turn on your microphone, Mr. Corrigan, because we want to hear you.

Mr. CORRIGAN. This is getting a little frustrating. In terms of derivatives, first of all, as a general matter, and I will come to Goldman Sachs in a minute, the fact of the matter is that over the past few years, there have been substantial improvements made in the entire infrastructure surrounding the way derivatives are traded, the practices for margining, the practices for collateral, the practices for closeout, and we are now, as you know, in the first stages of getting most derivatives through so-called "CCPs," central clearing counterparty things, that clearly is a potentially huge reduction in systemic risk associated with derivatives activities in general. And that effort is still ongoing. I personally am very involved with that effort and Goldman Sachs certainly is one of the most enthusiastic supporters of all of those initiatives.

Now, on the risk profile questions, as I think everyone knows, balance sheets are an imperfect indicator of financial profiles in general. But it is also true that in all of the risk metrics that organizations like Goldman Sachs and others use these days, in terms of all forms of stress tests and other contingent-type analyses that are done daily. All aspects of exposures, gross and net, margined, unmargined, *et cetera*, are taken into account in a context in which risk models in and of themselves are only one metric that is used in this process. And there are literally dozens of other metrics that are used to try to take account of the fact that risk models by their very nature are backward-looking, and as a result, are inherently flawed. We all know that and we try in the best ways that we can to take account of that in terms of how we think about risk.

In addition to that, all of the stress tests and other things that are done in risk mitigation efforts are done and are looked at by the authorities, not just in the United States but around the world.

So again, I am not Pollyanna-ish. I think I understand the risks associated with derivatives and most other things that you think about as well as anybody else. I spend a substantial part of my time trying to build and help the industry build better mousetraps to be able to deal with risk and risk mitigation.

So again, I am sure I make mistakes. I am sure I don't get it right every time. But I also am sure that I have had as much experience over what is now 43 or 44 years in dealing with these questions and these issues on both sides of the street.

Senator REED. No, we appreciate that, Mr. Corrigan. Your leadership of the Federal Reserve Bank of New York was a great contribution.

Mr. CORRIGAN. Thank you.

Senator REED. I have this feeling, though, in terms of regulation that there is a 27-year-old—

Mr. CORRIGAN. There is.

Senator REED. —across the table from you talking about why your risk models are wrong, and I think you win that conversation every time, and that is one of the problems we have in terms of—

Mr. CORRIGAN. I agree with that, Senator.

Chairman DODD. Jack added to the age. I said they were 22 yesterday.

[Laughter.]

Senator REED. They spent some time in the Army.

Chairman DODD. There you go. That is a good thing to do.

Senator Merkley, I am going to let you know we have got a couple of minutes left before the vote closes out, so why don't you go ahead and finish up.

Senator MERKLEY. I have the same microphone problem. There we go.

Mr. Corrigan, you seemed a little sensitive when it was suggested that Goldman Sachs was bailed out, if I caught your reaction right there. So to the—

Mr. CORRIGAN. Let me just, if I could, be very clear on this. I was reacting more to the specific language that was used. Look, there is no question—none whatsoever—that when you look at the totality of the steps that were taken by central banks and governments, particularly in 2008, that Goldman Sachs was the beneficiary of this. There is no doubt whatsoever about that, as well as everybody else. I mean, that is what those extraordinary measures were all about.

So again, I am not suggesting for 1 minute that Goldman Sachs was not a beneficiary of these initiatives. It was, clearly.

Chairman DODD. Let me—Senator, we have a minute left on the vote on the floor. I will leave the record open, but I am afraid we are going to have to leave ourselves or else we will miss a vote, so we are going to have to terminate the hearing. I apologize.

Senator MERKLEY. Thank you all very much.

Chairman DODD. And let me thank all of you very, very much. We could literally go on all day. You have been tremendously valuable, your testimony. We would like to follow up with you on some of these ideas and suggestions as we are trying to draft this legislation. I think we need further conversation.

Gerry, we thank you for your long testimony you submitted. It is very valuable to have that, as well, as part of the record.

John Reed, good to see you again, as well.

Hal, we love having you back here.

Barry, you are always welcome at the Committee.

And Professor Johnson, thank you for your presence here today, as well.

The Committee will stand adjourned.

[Whereupon, at 12:48 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Thank you Mr. Chairman.

On Tuesday, we heard from Paul Volcker, Chairman of the President's Economic Recovery Advisory Board, and from Treasury Deputy Secretary Wolin, about the Administration's most recent regulatory reform proposals.

I remain willing to consider any proposal that will strengthen our regulatory framework and help our economy.

Before we do so, however, we must understand the objectives of any proposal, and how those objectives are to be met.

The newest proposals are the so-called "Volcker Rule" to ban proprietary trading and hedge fund activities from firms with insured depositories, as well as limits on a bank's share of market liabilities.

The stated objective of the Administration's newest proposals is to enhance the safety of the banking system. I certainly agree with that.

Unfortunately, the manner in which the Administration's proposals will accomplish that objective remains elusive.

With respect to placing limitations on the proprietary trading activities of banks, Chairman Volcker and Mr. Wolin seem conflicted on how regulators could, in practice, distinguish proprietary trades from trades made by banks to help fulfill customer needs.

Chairman Volcker said that regulators should not be given the discretion to place restrictions on proprietary trading. Yet, when pressed for details on how the regulations would be implemented, Mr. Wolin stated: "Like an awful lot of banking law and a lot of the proposals, lots will be left to the regulators to implement in a very detailed way."

When I asked about size limits, and how regulators would define "excessive growth," Chairman Volcker paraphrased the late Justice Potter Stewart: "You know it when you see it."

Mr. Wolin failed to provide any more clarity when he said: "We do not have the details of that fully nailed down."

As I stated on Tuesday, the manner in which the President introduced these new ideas is not conducive to developing thoughtful, comprehensive reform legislation.

Chairman Dodd and I have made meaningful progress in our discussions on regulatory reform. It is my hope that we will continue to do so.

Our overarching goal must remain eliminating taxpayer bailouts while establishing the strongest, most competitive, and economically efficient regulatory structure possible.

Achieving this goal will involve consolidating our financial regulators, modernizing derivatives regulation, and strengthening consumer protection without undermining the safety and soundness of our financial institutions. In my view, these goals are not negotiable.

We have a unique opportunity to make significant and necessary changes on a bipartisan basis. Whether we seize this opportunity remains to be seen.

Thank you Mr. Chairman.

PREPARED STATEMENT OF E. GERALD CORRIGAN

MANAGING DIRECTOR, GOLDMAN, SACHS AND CO.

FEBRUARY 4, 2010

Introduction

Chairman Dodd, Ranking Minority Member Shelby, and Members of the Committee, I am thankful for this opportunity to share with you my views on the urgently needed financial reform process in the wake of the financial crisis. As the Committee knows, in my earlier career at the Fed and in my current second career in the private sector, public policy issues relating to the quest for greater financial stability have been a subject of continuing interest to me.

The views I will express today on financial reform are very much driven by what I consider to be in the best interest of long-term financial stability. Having said that, I cannot deny that there are instances in which my thinking about specific issues has been influenced by my tenure as an employee of Goldman Sachs and by what I have seen transpire during that period. To cite one clear example, in a sharp departure with my earlier thinking, I now recognize the value and importance of the so-called "fair value" or mark-to-market accounting.

At the center of the great debate about financial reform is the universal agreement that the "Too Big to Fail" problem must be forcefully resolved in order to pro-

vide comfort that future problems with failures of large and complex financial institutions will not be “bailed out” with tax payer money. Achieving that goal will not be easy but it is not impossible.

My formal statement contains four sections as follows:

- Section I: The Financial Reform Agenda
- Section II: Alternative Financial Structures in Perspective
- Section III: The Merits of Alternative Financial Structures
- Section IV: The Challenges Associated With Enhanced Resolution Authority

Section I: The Financial Reform Agenda

In looking to the future, almost everyone who has seriously studied the causes of the crisis agrees that certain basic reforms are a must. In summary form, those basic reforms include the following:

1. The creation of a so-called “systemic regulator.” Among other things, the mission of the systemic regulator would include oversight of all systemically important institutions and, importantly, looking beyond individual institutions in order to better anticipate potential sources of economic and financial contagion risk including emerging asset price bubbles. Anticipating future sources of contagion is difficult but not impossible.
2. Higher and more rigorous capital and liquidity standards that recognize the compelling reality that managing and supervising capital adequacy and liquidity adequacy must be viewed as a single discipline.
3. Substantial enhancement in risk monitoring and risk management and more systematic prudential oversight of these activities.
4. The increased reliance by institutions and their supervisors on (1) stress tests; (2) so-called “reverse” stress tests; and (3) rigorous scenario analysis of truly extreme contingencies.
5. Efforts to intensify the never ending task of strengthening the infrastructure of the global financial system.
6. The creation of a flexible and effective framework for the timely and orderly wind-down of failing large and complex financial institutions (the Enhanced Resolution Authority discussed in Section IV).
7. Substantially enhanced cross-border cooperation and coordination on a wide range of issues from accounting policy and practice to more uniform prudential standards to better coordinated macroeconomic policies.

I believe that these measures—coupled with others that are in the House Bill such as tightening up the administration of Section 13 (3) of the Federal Reserve Act—will, over time, reduce the probability of future financial crises and materially help to limit or contain the damage caused by crises. Having said that, I want to underscore three key points: First; the execution challenges associated with this reform agenda are enormous. Second; the reforms are a “package deal” such that if we fail to achieve any one of these measures the prospects for success in the others will be compromised. Third; if we are successful in implementing the agenda over a reasonable period of time the case for wholesale restructuring of the financial system would hardly be compelling.

Section II: Alternative Financial Structures in Perspective

At the risk of considerable oversimplification, there are three somewhat overlapping suggestions on the table that are calling for a major restructuring of the core of the financial system both domestically and internationally. The more extreme of the three is the so-called “Narrow Bank Model” which, in effect, suggests that “banks” should essentially take deposits and make loans. The second approach would limit the scope of activities in banks and in companies that own banks but would allow nonbank affiliates of bank holding companies to conduct certain other financial activities including the underwriting of debt and equity securities while sharply curtailing or prohibiting banks and bank holding companies from engaging in “proprietary” trading and operating or sponsoring hedge funds and private equity funds.

The third approach is the view that subject to a comprehensive and rigorous family of reforms as outlined in Section I, most large integrated financial institutions would be allowed to maintain much of their current configuration while being subject to much more demanding consolidated supervision.

To many, the frame of reference surrounding the debate on these alternatives seems to be very much a matter of black and white. If we were starting with a clean slate, that might be the case. Unfortunately, we are not starting with a clean

slate—far from it. Therefore, allow me to briefly focus on a few observations that—in my judgment—frame the perspective to be considered in shaping the debate on alternative financial structures.

First; I have always believed that banks (whether stand alone or part of a Bank Holding Company) are special. Among other things, that is one of the reasons I agreed to take on the role of nonexecutive chairman of the Goldman Sachs Bank when Goldman became a Bank Holding Company in the fall of 2008.

Second; under existing law and regulation there are now in place rigorous restrictions as to the activities that may be conducted in a bank that is part of a Bank Holding Company and even more rigorous standards limiting transactions that can occur between the bank, its holding company and its nonbank affiliates. Also, under precrisis rules regarding the administration of the discount window, access to the discount window applied only to the bank and such access did not extend, either directly or indirectly, to the Holding Company or the Bank's nonbank affiliates. As the Fed winds down its crisis driven extraordinary interventions, I believe we should return to the precrisis rules regarding access to the discount window so long as Section 13 (3) lending remains a possibility in extreme circumstances.

Third; under existing law and regulation, the Federal Reserve, as the consolidated prudential supervisor of all U.S. Bank and Financial Services Holding Companies, already has broad discretionary authority to remove officers and directors, cut or eliminate dividends, shrink the balance sheet, *etc.* The Bill passed by the House in December would further strengthen this authority and extend it to systemically important financial institutions even if they do not own or control a bank.

While on the subject of consolidated supervision, allow me to say a few words about the experience of Goldman Sachs since the Fed (working with other regulators) became its consolidated supervisor 16 months ago. First, and most importantly, I would describe that relationship as open, highly constructive, and very demanding. The Fed has now completed comprehensive full scale examinations of the Bank and the Group and reported the results of such examinations to both the Boards of the Group and the Bank. In addition, a large number of targeted exams and so-called “discovery reviews” have been completed or are in progress. In the case of major forward-looking supervisory initiatives on the part of the Fed in collaboration with other supervisory bodies—both domestic and international—I personally have actively participated in all such discussions. Finally, and to put a little color on this subject, on more than a few occasions my high-level associates at Goldman Sachs have said to me something along the following lines: “these guys (referring to the supervisors) ask damn good questions.”

Fourth; given all that we have been through over the past 2 years, many observers are raising the perfectly natural question of whether society really needs large and complex financial institutions. Whatever else can be said about such large and complex financial institutions, financial services is one of the few sectors of the economy that make a consistent positive contribution to the U.S. balance of payments.

Balance of payment issues aside, I strongly believe that well managed and supervised large integrated financial institutions play a constructive and necessary role in the financial intermediation process which is central to the public policy goals of economic growth, rising standards of living and job creation.

While the business models of the relatively small number of large and complex financial institutions in the U.S. and abroad differ somewhat from one to another, as a broad generalization most are engaged to varying degrees in (1) traditional commercial banking; (2) securities underwriting; (3) a range of trading activities including at least some elements of “proprietary” trading; (4) financial advisory services; (5) asset management services including the management of so-called “alternative” investments; (6) private banking; and (7) elements of principal investing.

All of these large integrated financial groups are indeed large with balance sheets ranging from the high hundreds of billions to \$2.0 trillion or so. Among other things, it is their size that allows these institutions to meet the financing needs of large corporations—to say nothing of the financing needs of sovereign governments. The fact that so many of these large corporations operate on a global scale is one of the reasons why almost all large financial intermediaries also have a global footprint. As an entirely practical matter, it is very difficult to imagine how the vast financing needs of corporations and governments could be met on anything like today's terms and conditions absent the ability and willingness of these large intermediaries to place at risk very substantial amounts of their own capital in serving these companies and governments. One of the best examples of this phenomenon is the role large intermediaries have played in the recent past in raising badly needed capital for the financial sector itself.

For example, over the past 2 years banking institutions in the U.S. and abroad have raised more than one-half trillion dollars in fresh private capital and the cap-

ital raising meter is still running. While there were some private placements, the overwhelming majority of such capital was raised in the capital markets and the associated underwriting, operational and reputational risks associated with such capital raising, were absorbed by various combinations of the small number of large integrated financial groups. Moreover, many of these transactions took the form of rights offerings which involve extended intervals of time between pricing and final settlement thus elevating underwriting risks. The ability and willingness of these large integrated financial groups to assume these risks depends crucially on large numbers of experienced investment bankers and highly skilled equity market specialists who are able to judge the tone and depth of the markets in helping clients shape the size, structure, and pricing for such transactions.

More broadly, to a greater or lesser degree, most of these large integrated financial groups also act as day-to-day market makers across a broad range of financial instruments ranging from Treasury securities to OTC derivatives. The daily volume of such market activities is staggering and can be measured in hundreds of thousands—if not millions—of transactions. As market makers, these institutions stand ready to purchase or sell financial instruments in response to their institutional (and sometimes governmental) clients and counterparties. As such, market-making transactions—by their very nature—entail substantial capital commitments and risk-taking by the market maker. However, the capital that is provided in the market-making process is the primary source of the liquidity that is essential to the efficiency and price discovery traits of financial markets. Moreover, in today's financial environment, market makers are often approached by clients to enter into transactions that have notional amounts that are measured in hundreds of millions, if not billions, of dollars. Since transactions of these sizes cannot be quickly laid off or hedged, the market makers providing these services to institutional clients must have world-class risk management systems and robust amounts of capital and liquidity. Thus, only large and well capitalized institutions have the resources, the expertise and the very expensive technological and operating systems to manage these market-making activities. Having said that, it is also true that some of these activities are, indeed, high risk in nature. Thus, the case for greater managerial focus, heightened supervisory oversight and still larger capital and liquidity cushions for certain activities are all part of the postcrisis reform agenda.

Fifth; in terms of both competition and regulatory arbitrage there is a critical international component to the outcome of the debate on alternative financial market structure in the U.S. That is, if the United States adopted a materially different and more restrictive statutory framework for banking and finance than, for example, Europe, the outcome could easily work to the competitive disadvantage of U.S. institutions. Similarly, such an outcome would, inevitably, introduce new pressures in the area of financial protectionism which, given the existing threats on the trade protection front, is one of the last things our country and the world need. Finally, if there are material international differences in financial structure and the “rules of the road” governing banking and finance, it is inevitable that one way or another, clever people, aided by highly sophisticated technology, will find ways to game the system.

To summarize, even before approaching the very complex issue surrounding the pros and cons of alternative financial structures and effectively resolving the “Too Big to Fail” problem, we must recognize that even modest financial restructurings that would directly affect only a small number of institutions worldwide raise many questions about the laws of unintended consequences especially in the context of the larger agenda for reform discussed in Section I.

Section III: The Merits of Alternative Financial Structures

There is no question that the drive to shrink the size and activities of large and complex financial institutions is understandably driven by the political and public outrage about the use of tax payer money to “bail out” institutions that were deemed to be “Too Big to Fail.” Given that reality, it follows that many observers believe that the easiest way to solve the problem is via some combination of shrinking the size of these institutions, and/or restricting their activities in ways that will curtail risk and mitigate the conflicts of interest.

Having said that, it is also true that while financial excesses were unquestionably one of the causes of the crisis, shortcomings in public policy were important contributing factors. Similarly, not all “banks” that received direct tax payer support were large and complex institutions. Moreover, the largest single source of write-downs and losses in financial institutions—complex or not—occurred in traditional lending activities not trading activities. Regrettably, these lending driven losses and write-downs were magnified by certain classes of securitization especially very complex and highly leveraged instruments. Finally, it is also undeniable that all classes of

financial institutions—big banks, small banks, investment banks (including Goldman Sachs) and so-called “near banks”—to say nothing of businesses small and large—benefited substantially from the large scale extraordinary measures taken by governments and central banks to cushion the economic and financial fallout of the crisis.

The most radical of the restructuring suggestions is the so-called “narrow bank” which would essentially take deposits and make loans. As I see it, and with the exception of community banks, this approach is a nonstarter given the long history of credit problems over the business and credit cycle. In other words restricting diversification of risk and revenues is hardly a recipe for stability.

A less extreme, but still transformational structural change has been suggested by Chairman Volcker and endorsed by President Obama. While the broad intent of the Volcker approach is quite clear there are a number of open definitional and important technical details that are yet to be clarified. One area of particular importance relates to the definition of proprietary trading and, in particular, the distinction between “prop” trading and market making. As I see it, client-driven market making and the hedging and risk management activities growing out of such market making are natural activities of banks and Bank Holding Companies. As such, these activities are subject to official supervision, including on site inspections, capital and liquidity standards and various forms of risk related stress tests.

The Volcker plan would also prohibit “banks” and Bank and Financial Services Holding Companies from owning or sponsoring hedge funds and private equity funds. I believe that the financial risks associated with such ownership or sponsorship can be effectively managed and limited by means short of outright prohibition although bank owners or sponsors of such funds should not be permitted to inject fresh capital into an existing fund without regulatory approval.

More generally, it should be noted that hedge funds and private equity funds are providing both equity and debt financing to small and medium sized businesses in such vital areas as alternative energy and technology ventures. Given the long term benefits of these activities, I also believe there is something to be said for the proposition that, subject to appropriate safeguards, regulated Bank Holding Company presence in the hedge fund and private equity fund space can help to better promote best industry practice.

I am also mindful of the conflict of interest issue raised by Chairman Volcker. There is nothing new about potential conflicts in banking and finance. However, it cannot be denied that in the world of contemporary finance—with all of its complexities and applied technology—managing potential conflicts has become much more challenging. Reflecting that fact of life, so-called “Chinese Walls” segregating some business units from others is a necessary, but not sufficient, condition for managing potential conflicts. That is why at Goldman Sachs (and other large integrated intermediaries) conflict management policies and procedures are constantly evolving and improving.

Goldman Sachs has established numerous committees and processes to help mitigate potential conflicts. We have a high level Firmwide Business Practices Committee which focuses on operational and reputational risk, including conflict management. We have a dedicated and independent high level worldwide Conflict Management team. We have a Firmwide Risk Committee which focuses on financial risk. The Firm’s independent Legal and Compliance divisions, both of which have centralized teams of experts and high level officials who are embedded, but still independent, within all of the revenue producing business units, contribute to conflicts management. All of these committees and business areas are headed by senior officers who sit on the Management Committee. Side by side we have a Suitability Committee and a New Products Committee. In addition, our Capital Committee and Commitments Committee as well as all Division Heads share in the responsibility of helping to manage conflicts and reputational risk.

Section IV: The Challenges Associated With Enhanced Resolution Authority

There is little doubt that a well designed and well executed framework of Enhanced Resolution Authority can address the Too Big to Fail problem and the related Moral Hazard problem. However, it is also true that a poorly designed and poorly executed approach to Enhanced Resolution Authority could produce renewed uncertainty and instability. Indeed, under the very best of circumstances, the timely and orderly wind-down of any systemically important financial institution—especially one with an international footprint—is an extraordinarily complex task. That is why, at least to the best of my recollection, we have never experienced such an orderly wind-down anywhere in the world. In other words, even if we successfully implement all of the reforms outlined in Section I of this statement, that success by itself, will not ensure that Enhanced Resolution Authority can achieve its desired

effects. Thus, great care must be used in the design of the approach to law and regulation for a system of Enhanced Resolution Authority.

I, of course, have no monopoly on thoughts on how to best approach this task. On the other hand, as someone who has devoted much of my career to improving what I like to call the plumbing of the financial system I do have some suggestions as to (1) certain principles that I believe should guide the effort and (2) certain prerequisites that should be in place to guide the execution of a timely and orderly wind-down or merger of a failing systemically important financial institution.

Guiding Principles

First; the authorizing legislation and regulations must not be so rigid as to tie the hands of the governmental bodies that will administer those laws and regulations because it is literally impossible to anticipate the future circumstances in which the authorities will be required to act.

Second; in my judgment, the authority and responsibility to carry out Enhanced Resolution Authority in a given situation should be vested in governmental bodies that have sufficient experience with the type of institution being resolved.

Third; Enhanced Resolution Authority should be administered using the ongoing approach which probably means the troubled institution would be placed into temporary conservatorship or a similar vehicle allowing that institution to continue to perform and meet its contractual obligations for a limited period of time.

As a precondition for conservatorship, one or more of the Executive Officers and the Board of the institution would be removed. The ongoing approach has many benefits including (1) preserving the value of assets that might be sold at a later date; (2) minimizing the dangerous and panic prone process of simultaneous close out by all counterparties and the need of such counterparties to then replace their side of many of the closed-out positions; and (3) reducing, but by no means eliminating, the very difficult and destabilizing cross-border events that could otherwise occur as witnessed in the Lehman episode. However, the ongoing approach is not without its problems, one of which is the sensitive question of how well an institution in conservatorship for a limited period of time can fund itself.

Fourth: to the maximum extent possible, the rights of creditors and the sanctity of existing contractual rights and obligations need to be respected. Indeed, if the exercise of Enhanced Resolution Authority is seen to arbitrarily violate creditor rights or override existing contractual agreements between the troubled institution and its clients, its creditors, and its counterparties, the goal of orderly wind-down could easily be compromised and the resultant precedent could become a destabilizing source of ongoing uncertainty.

Finally; the orderly wind-down of any large institution—particularly such an institution having a global footprint—is a highly complex endeavor that will take patience, skill and effective communication and collaboration with creditors, counterparties and other interested parties. Shrinking a balance sheet or selling distinct businesses or classes of assets or liabilities may prove relatively simple but the winding down of trading positions, hedges, positions in financial “utilities” such as payments, clearance and settlement systems is quite another matter.

Prerequisites for Success:

First; as a part of the reform of supervisory policy and practice, supervisory authorities responsible for systemically important institutions must work to insure that “prompt corrective action” becomes a reality not merely a slogan.

Second; the official community must work with individual systemically important institutions to ensure that all such institutions have—or are developing—the systems and procedures to provide the following information in a timely fashion.

- Comprehensive data on all exposures to all major counterparties and estimates of all such exposures of counterparties to the failing institution
- Valuations consistent with prevailing market conditions that are available across a substantially complete range of the firm’s asset classes (including derivative and securities positions)
- Accurate and comprehensive information on a firm’s liquidity and the profiles of its assets and liabilities
- Fully integrated, comprehensive risk management frameworks capable of assessing the market, credit, and liquidity risks associated with the troubled institution
- Legal agreements and transaction documents that are available in an organized, accessible form

- Comprehensive information on the firm's positions with exchanges, clearing houses, custodians and other institutions that make up the financial system's infrastructure

I am under no illusion that these guiding principles and prerequisites are anything close to the last word in seeking assurances that Enhanced Resolution Authority can deliver on the promise of a stability driven solution to the "Too Big to Fail" problem. On the other hand, I very much hope these suggestions will help to stimulate discussion and debate on this critically important subject.

PREPARED STATEMENT OF SIMON JOHNSON

RONALD KURTZ PROFESSOR OF ENTREPRENEURSHIP, MIT SLOAN SCHOOL OF MANAGEMENT; AND
SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS; AND
COFOUNDER OF [BASELINE SCENARIO.COM](http://BaselineScenario.com)

FEBRUARY 4, 2010

A. General Principles ¹

1) The broad principles behind the so-called "Volcker Rules" are sound. As articulated by President Obama at his press conference on January 21, the priority should be to limit the size of our largest banks and to reduce substantially the risks that can be taken by any financial entity that is backed, implicitly or explicitly, by the Federal Government.

2) Perceptions that certain financial institutions were "too big to fail" played a role in encouraging reckless risk-taking in the run-up to the financial crisis that broke in September 2008. Once the crisis broke, the Government took dramatic and unprecedented steps to save individual banks and nonbanks that were large relative to the financial system; at the same time, relatively small banks, hedge funds, and private equity and other investment funds were either intervened by the FDIC (for banks with guaranteed deposits) or just allowed to go out of business (including through bankruptcy).

3) Looking forward, we face a major and undeniable problem with the "too big to fail" institutions that became more powerful (in economic and political terms) as a result of the 2008–09 crisis and now dominate our financial system. Implementing the principles behind the Volcker Rules should be a top priority.

4) As a result of the crisis and various Government rescue efforts, the largest 6 banks in our economy now have total assets in excess of 63 percent of GDP (based on the latest available data; details of the calculation and related information are available in "13 Bankers"). This is a significant increase from even 2006, when the same banks' assets were around 55 percent of GDP, and a complete transformation compared with the situation in the U.S. just 15 years ago—when the 6 largest banks had combined assets of only around 17 percent of GDP.

5) The credit markets are convinced that the biggest banks in the United States are so important to the real economy that, if any individual bank got into trouble, it would be rescued in such a way that creditors would be fully protected. As a result, the implied probability of default on debt issued by these mega-banks is very low—as reflected, for example, in their current credit default swap spreads.

6) The consequent low cost of credit for mega-banks—significantly below what is paid by smaller banks that can fail (*i.e.*, banks that can realistically be taken over through a FDIC intervention)—constitutes a form of unfair subsidy that enables the biggest banks to become even larger. Without a size cap on individual bank size, we will move toward the highly dangerous situation that prevails in some parts of Western Europe—where individual banks hold assets worth more (at least on paper, during a boom) than their home country's GDP.

7) Just to take one example, the Royal Bank of Scotland (RBS) had assets—at their peak—worth roughly 125 percent of U.K. GDP. The mismanagement and effective collapse of RBS poses severe risks to the U.K. economy, and the rescue will cost the taxpayer dearly. Iceland is widely ridiculed for allowing banks to build up assets (and liabilities) worth between 11 and 13 times GDP, but the biggest four banks in the U.K. had bank assets worth over 3 times GDP (and total bank assets were

¹ This testimony draws on joint work with James Kwak, including "13 Bankers" (forthcoming, March 2010) and "The Quiet Coup" (*The Atlantic*, April, 2009), and Peter Boone, particularly "The Next Financial Crisis: It's Coming and We Just Made It Worse" (*The New Republic*, September 8, 2009). Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, *e.g.*, at <http://BaselineScenario.com>, where we also provide daily updates and detailed policy assessments for the global economy.

substantially higher, by some estimates as much as 6 times GDP)—and the two largest banks in Switzerland held assets that were worth over 8 times GDP. When there is an implicit Government subsidy to bank size and growing global opportunities to export (subsidized) financial services, market forces do not limit how large banks and nonbank financial institutions can become relative to the domestic economy. In fact, as financial globalization continues, we should expect the largest U.S. banks—left unchecked—to become even bigger in dollar terms and relative to the size of our economy.

8) At the same time, under the current interpretation of our financial rules, a bank such as Goldman Sachs now has full access to the Fed's discount window (as a bank holding company)—yet also retains the ability to make risky investments of all kinds anywhere in the world (as it did when it was an investment bank, before September 2008). In a very real sense, the U.S. Government is now backing the world's largest speculative investment funds—without any effective oversight mechanisms.

9) Under the framework now in place, we are set up for another round of the boom-bailout-bust cycle that the head of financial stability at the Bank of England now terms a “doom loop.” The likely consequences range from terrible, in terms of pushing up our net Government debt by another 40 percentage points of GDP (or more), as we struggle again to prevent recession from becoming depression, to catastrophic—if we fail to prevent a Second Great Depression.

10) In this context, reining in the size of our largest banks is not only an appealing proposition, it is also compelling. There is no evidence for economies of scale in banking over \$100 billion of total assets (measured in today's dollars). As a result, the growth of our largest banks since the early 1990s has been entirely without social benefits. At the same time, the crisis of 2008–09 manifestly demonstrates the very real social costs: the revised data will likely show more than 8 million net jobs lost since December 2007—due to more than a decade of reckless risk-taking involving large financial institutions.

11) The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 specified a size cap for banks: No single bank may hold more than 10 percent of total retail deposits. This cap was not related to antitrust concerns as 10 percent of a national market is too low to imply pricing power. Rather this was a sensible macroprudential preventive measure—don't put all your eggs in one basket. Unfortunately, since 1994 two limitations of Riegle-Neal have become clear, (1) the growth of big banks was not fueled by retail deposits but rather by various forms of “wholesale” financing, and (2) the cap was not enforced by lax regulators, so that Bank of America, JPMorgan Chase, and Wells Fargo all received waivers in recent years.

12) While the U.S. financial system has a long tradition of functioning well with a relatively large number of banks and other intermediaries, in recent years it has become transformed into a highly concentrated system for key products. The big four have half of the market for mortgages and two-thirds of the market for credit cards. Five banks have over 95 percent of the market for over-the-counter derivatives. Three U.S. banks have over 40 percent of the global market for stock underwriting. This degree of market power is dangerous in many ways.

13) These large banks are widely perceived—including by their own management, their creditors, and Government officials—as too big to fail. The executives who run these banks obviously have an obligation to make money for their shareholders. The best way to do this is to take risks that pay off when times are good and that result in bailouts—creating huge costs for taxpayers and all citizens—when times are bad.²

14) This incentive system distorts market outcomes, encourages reckless risk-taking, and will lead to serious trouble. While reducing bank size is not a panacea and should be combined with other key measures that are not yet on the table—including a big increase in capital requirements—finding ways to effectively reduce and then limit the size of our largest banks is a necessary condition for a safer financial system.

B. Assessment of Bank Size

1) The counterargument is that big banks provide benefits to the economy that cannot be provided by smaller banks. There are also claims that the global competitiveness of U.S. corporations requires American banks be at least as big as the banks in any other country. Another argument is that large financial institutions enjoy significant economies of scale and scope that make them more efficient, help-

²For more analytical analysis and relevant data on this point, see “Banking on the State”, by Andrew Haldane and Piergiorgio Alessandri, *BIS Review* 139/2009.

ing the economy as a whole. Finally, it is argued global banks are necessary to provide liquidity to far-flung capital markets, making them more efficient and benefiting companies that raise money in those markets.

2) There is weak or no hard empirical evidence supporting any of these claims.

3) Multinational corporations do have large, global financing needs, but there are currently no banks that can supply those needs alone; instead, corporations rely on syndicates of banks for major offerings of equity or debt. And even if there were a bank large enough to meet all of a large corporation's financial needs, it would not make sense for any nonfinancial corporation to restrict itself to a single source of financial services. It is much preferable to select banks based on their expertise in particular markets or geographies.

4) In addition, U.S. corporations already benefit from competition between U.S. and foreign banks, which can provide identical financial products; there is no reason to believe that the global competitiveness of our nonfinancial sector depends on our having the world's largest banks.

5) There is also very little evidence that large banks gain economies of scale beyond a low size threshold.

a. Economies of scale vanish at some point below \$10 billion in assets.³

b. The 2007 Geneva Report on "International Financial Stability", coauthored by former Federal Reserve vice chair Roger Ferguson, found that the unprecedented consolidation in the financial sector over the previous decade had led to no significant efficiency gains, no economies of scale beyond a low threshold, and no evident economies of scope.⁴

c. Since large banks exhibit constant returns to scale (they are no more or less efficient as they grow larger), and we know that large banks enjoy a subsidy due to being too big to fail, "offsetting diseconomies must exist in the operation of large institutions"—that is, without the "too big to fail" subsidy, large banks would actually be less efficient than midsize banks.⁵

d. There is evidence for increased productivity in U.S. banking over time, but this is due to improved use of information technology—not increasing size or scope.⁶

6) Large banks do dominate customized (over-the-counter) derivatives. But this is primarily because of the implicit taxpayer subsidy they receive—again, because they are regarded as too big to fail, their cost of funds is lower and this gives them an unfair advantage in the marketplace. There is no sense in which this market share is the outcome of free and fair competition.

7) The fact that "end-users" of derivatives share in the implicit Government subsidy should not encourage the continuation of "too big to fail" arrangements. This is a huge and dangerous form of support for private interests at the expense of the taxpayer and—because of the apparent downside risks—of everyone who can lose a job or see their wealth evaporate in the face of an economic collapse.

8) There are no proven social benefits to having banks larger than \$100 billion in total assets. Vague claims regarding the social value of big banks are not backed up by data or reliable estimates. This should be weighed against the very obvious costs of having banks that are too big to fail.

C. Actions Needed

1) While the general principles behind the Volcker Rules make sense and there is no case for keeping our largest banks anywhere near their current size, the specific proposals outlined so far by the Administration are less persuasive.

³Dean Amel, Colleen Barnes, Fabio Panetta, and Carmelo Salleo, "Consolidation and Efficiency in the Financial Sector: A Review of the International Evidence", *Journal of Banking and Finance* 28 (2004): 2493–2519. See also Stephen A. Rhoades, "A Summary of Merger Performance Studies in Banking, 1980–93, and an Assessment of the 'Operating Performance' and 'Event Study' Methodologies", Federal Reserve Board Staff Studies 167, summarized in Federal Reserve Bulletin July 1994, complete paper available at <http://www.federalreserve.gov/Pubs/staffstudies/1990-99/ss167.pdf>: "In general, despite substantial diversity among the nineteen operating performance studies, the findings point strongly to a lack of improvement in efficiency or profitability as a result of bank mergers, and these findings are robust both within and across studies and over time." See also Allen N. Berger and David B. Humphrey, "Bank Scale Economies, Mergers, Concentration, and Efficiency: The U.S. Experience", Wharton Financial Institutions Center Working Paper 94-24, 1994, available at <http://fic.wharton.upenn.edu/fic/papers/94/9425.pdf>.

⁴Roger W. Ferguson, Jr., Philipp Hartmann, Fabio Panetta, and Richard Portes, *International Financial Stability* (London: Centre for Economic Policy Research, 2007), 93–94.

⁵Edward J. Kane, "Extracting Nontransparent Safety Net Subsidies by Strategically Expanding and Contracting a Financial Institution's Accounting Balance Sheet", *Journal of Financial Services Research* 36 (2009): 161–168.

⁶Kevin J. Stiroh, "Information Technology and the U.S. Productivity Revival: What Do the Industry Data Say?" *American Economic Review* 92 (2002): 1559–1576.

2) Capping the size of our largest banks at their current level today does not make much sense. It is highly unlikely that, after 30 years of excessive financial deregulation, the worst crisis since the Great Depression, and an extremely generous bailout that we found ourselves with the “right” size for big banks.

3) Furthermore, limiting the size of individual banks relative to total nominal liabilities of the financial system does not make sense, as this would not be “bubble proof”. For example, if housing prices were to increase ten-fold, the nominal assets and liabilities of the financial system would presumably also increase markedly relative to GDP. When the bubble bursts, it is the size of individual banks relative to GDP that is the more robust indicator of the damage caused when that bank fails—hence the degree to which it will be regarded as too big to fail.

4) Also, splitting proprietary trading from integrated investment-commercial banks would do little to reduce their overall size. The “too big to fail” banks would find ways to take similar sized risks, in the sense that their upside during a boom would still be big and the downside in a bust would have dramatic negative effects on the economy—and force the Government into some sort of rescue to prevent further damage.

5) The most straightforward and appealing application of the Volcker Principles is: Do not allow financial institutions to be too big to fail; put a size cap on existing large banks relative to GDP, forcing these entities to find sensible ways to break themselves up over a period of 3 years.

6) CIT Group was not too big to fail in summer 2009; it then had around \$80 billion in total assets. Goldman Sachs was too big to fail in fall 2008, with assets over \$1 trillion. If Goldman Sachs were to break itself up into 10 or more independent companies, this would substantially increase the likelihood that one or more could fail without damaging the financial system. It would also greatly improve the incentives of Goldman management, from a social perspective, encouraging them to be much more careful.

7) Addressing bank size is not a panacea. In addition, capital requirements need to be strengthened dramatically, back to the 20–25 percent level that was common before 1913, *i.e.*, before the creation of the Federal Reserve, when the Government effectively had no ability to bail out major banks. Capital needs to be risk-weighted, but in a broad manner that is not amenable to gaming (*i.e.*, quite different from Basel II and related approaches).

8) Such strengthening and simplifying of capital requirements would go substantially beyond what the Obama administration has proposed and what regulators around the world currently have in mind. In November 2009, Morgan Stanley analysts predicted that new regulations would result in Tier 1 capital ratios of 7–11 percent for large banks—*i.e.*, below the amount of capital that Lehman had immediately before it failed.⁷

9) The capital requirements for derivative positions also need to be simplified and strengthened substantially. For this purpose derivative holdings need to be converted according to the “maximum loss” principle, *i.e.*, banks should calculate their total exposure as they would for a plain vanilla nonderivative position; they should then hold the same amount of capital as they would for this nonderivative equivalent. For example, if a bank sells protection on a bond as a derivative transaction, the maximum loss is the face value of the bond so insured. The capital requirement should be the same as when the bank simply holds that bond.

10) A strengthened and streamlined bankruptcy procedure for nonbank financial institutions makes sense. This will help wind up smaller entities more efficiently.

11) But improving the functioning of bankruptcy does not make “too big to fail” go away. When they are on the brink of failing, “too big to fail” banks are “saved” from an ordinary bankruptcy procedure because creditors and counterparties would be cut off from their money for months, which is exactly what causes broader economic damage. You can threaten all financial institutions with bankruptcy, but that threat is not credible for the biggest banks and nonbanks in our economy today. And if the Government did decide to make an example of a big bank and push it into bankruptcy, the result would likely be the kind of chaos—and bailouts—that followed the failure of Lehman in September 2008.

12) A resolution authority as sought by the Obama administration could help under some circumstances but is far from a magic bullet in the global world of modern finance. Some of the most severe complications of the Lehman bankruptcy occurred not in the United States, but in other countries, each of which has its own laws for dealing with a failing financial institution. These laws are often mutually inconsistent and no progress is likely toward an integrated global framework for

⁷ Research Report, Morgan Stanley, “Banking—Large and Midcap Banks: Bid for Growth Caps Capital Ask”, November 17, 2009.

dealing with failing cross-border banks. When a bank with assets in different countries fails, it is in each country's immediate interest to have the strictest rules on freezing assets to pay off domestic creditors (and, in some jurisdictions, to protect local workers). No other G-20 country, for example, is likely to cede to the United States the right to run a resolution process for banking activities that are located outside the U.S.

13) More broadly, solutions that depend on smarter, better regulatory supervision and corrective action ignore the political constraints on regulation and the political power of today's large banks. The idea that we can simply regulate huge banks more effectively assumes that regulators will have the incentive to do so, despite everything we know about regulatory capture and political constraints on regulation. It assumes that regulators will be able to identify the excess risks that banks are taking, overcome the banks' arguments that they have appropriate safety mechanisms in place, resist political pressure (from the Administration and Congress) to leave the banks alone for the sake of the economy, and impose controversial corrective measures that will be too complicated to defend in public. And, of course, it assumes that important regulatory agencies will not fall into the hands of people like Alan Greenspan, who believed that Government regulation was rendered largely unnecessary by the free market.

14) The "rely on better regulation" approach also assumes that political officials, up to and including the president, will have the backbone to crack down on large banks in the heat of a crisis, while the banks and the Administration's political opponents make accusations about socialism and the abuse of power. FDIC interventions (*i.e.*, taking over and closing down banks) currently do not face this challenge because the banks involved are small and have little political power; the same cannot be said of JPMorgan Chase or Goldman Sachs.

15) There are no perfect solutions to the problem we now face: a handful of banks and other financial institutions that are too big to fail. The Volcker Principles are sound—we should reduce the size of our largest banks and ensure that banks with implicit (and explicit) Government subsidies are not allowed to engage in risky undercapitalized activities.

16) However, the proposed details in the Volcker Rules do not go far enough. We should put a hard size cap, as a percent of GDP, on our largest banks. A fair heuristic would be to return our biggest banks to where they were, relative to GDP, in the early 1990s—the financial system, while never perfect, functioned fine at that time and our banks were internationally competitive, and there is no evidence that our nonfinancial companies were constrained by lack of external funding. (More details on this proposal are available in "13 Bankers".)

17) Much stronger capital requirements will reduce the chance that any individual financial institution fails. But financial failure is a characteristic of modern market economies that cannot be legislated out of existence. When banks and nonbank financial institutions fail, there is far less damage and much less danger if they are small.

PREPARED STATEMENT OF JOHN REED

RETIRED CHAIRMAN, CITIGROUP

FEBRUARY 4, 2010

It is probably too early to fully assess the nature and causes of our recent financial meltdown but the conversation about potential remedies is well underway. Given that fact, a few thoughts could be useful.

First, some "framing."

One, the crisis was clearly "man made," this was not the result of long standing and cumulative imbalances.

Second, there seems to have been a key failure that none of us anticipated, namely, individual institutions which are thought to take steps and exercise judgments to ensure their self-preservation turned out "not to have" or been incapable of so doing. (This clearly means that in designing a robust system, we cannot count on that capacity.)

Third, a financial system cannot be permitted to impact the real economy to the extent that it has.

Fourth, while much has been made of the low interest rate environment that accompanied the build up to the crisis, one would not design a financial system that could not function in such an environment.

Second, some casual factors that are worth noting.

One, a dominant business philosophy focusing on "shareholder value".

Two, almost frenetic activity in the creation and distribution of securitized products and derivatives. These turned out to be flawed as credits but further were not fully distributed to “knowledgeable investors” but to an incredible extent were inventoried on the balance sheet of “intermediaries” (e.g., Merrill Lynch, Citi).

Third, the absolute failure of the rating agencies in the performance of their only mission.

Fourth, the failure of supervision,

- In allowing the decapitalization of the sector.
- In ignoring the implications of “low doc, no doc” lending.
- In ignoring the levels of counterparty risk.
- In “missing” the fact that credit default swaps were insurance products, requiring reserves and oversight.

Fifth, the failure of policy in pushing the mortgage market through Freddie Mac and Fannie Mae to an uneconomic extent.

Third, if the aim is to create rules and limits, which on the one hand would significantly reduce the likelihood of a repeat of our recent experience, and on the other would support a healthy and creative industry, what would the rules and limits be?

First, capital should be significantly increased, maybe doubled. (I personally think the concept of Risk Adjusted Capital is flawed.)

Second, the funding structure (liquidity) of each institution should be the subject of annual review (not just “point in time”, averages and extremes over the year) and assessment by regulators and boards.

Third, the industry should be compartmentalized so as to limit the propagation of failures and also to preserve cultural boundaries.

Fourth, to the extent possible, traded products should flow through Exchanges.

Fifth, there is a good reason to create a Consumer Protection Agency with a clear and separate mandate.

PREPARED STATEMENT OF HAL S. SCOTT

NOMURA PROFESSOR OF INTERNATIONAL FINANCIAL SYSTEMS AT HARVARD LAW SCHOOL; AND

DIRECTOR OF THE COMMITTEE ON CAPITAL MARKETS REGULATION

FEBRUARY 4, 2010

Thank you, Chairman Dodd, Ranking Member Shelby, and Members of the Committee for permitting me to testify before you on the implications of the Volcker Rules for Financial Stability (Volcker Rules), as well as President Obama’s proposed size limitations on banks. I am testifying today in my own capacity and do not purport to represent the views of the Committee on Capital Markets Regulation.

Let me preface my testimony by stressing the urgent need for broad regulatory reform in light of the financial crisis on matters ranging from the structure of our regulatory system, to the reduction of systemic risk in the derivatives market, to improving resolution procedures for insolvent financial companies, to increasing consumer protection, and to revamping the GSEs. The Committee on Capital Markets Regulation dealt with these issues in its May 2009 Report titled “The Global Financial Crisis: A Plan for Regulatory Reform”.¹ These issues were also fully laid out in the Treasury Department’s June 2009 proposal on financial regulatory reform,² and have been vigorously debated in public meetings, the press, and Congressional hearings for months. These efforts have so far culminated in the Wall Street Reform and Consumer Protection Act (H.R. 4173) as well as in Senator Dodd’s thoughtful Discussion Draft. And I applaud the ongoing efforts of this Committee to reach bipartisan consensus on these issues. In my judgment, we should not hold up these important reforms while we debate activity and size limitations.

The Volcker Rules would limit the ability of banks³ to own, invest in, or sponsor a hedge fund or private equity fund, or to engage in “proprietary trading.” The size

¹This report contains 57 recommendations for making the U.S. financial regulatory structure more integrated, more effective and more protective of investors. Comm. on Capital Mkts. Reg., *The Global Financial Crisis: A Plan For Regulatory Reform* (May 2009).

²U.S. Dep’t of the Treasury, *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision And Regulation* (June 2009) [hereinafter Treasury White Paper], http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

³We use the term “banks” to refer generally to bank holding companies and their subsidiaries.

limitation would limit the market share of all financial institution liabilities beyond the current 10 percent market share cap applied to bank deposits.

At the outset, it is important to focus on the stated objective of these new proposals—to reduce bank risk so as to minimize the necessity of public rescue of banks that are “Too Big to Fail.” There is no question that we need to address the “Too Big to Fail” issue. We need to understand whether the conventional wisdom—that we cannot let large financial institutions fail, in the sense of imposing a full measure of losses on the private sector, whether they be equity or unsecured debt holders or counterparties—is actually true. The concern rests on an assumption that we cannot permit certain large and interconnected financial institutions to fail because such failure would trigger a chain reaction of other financial institution failures, with disruption to the entire economy.

In the notable \$85 billion Federal bailout of AIG, however, some question whether the asserted prospect of severe counterparty losses actually existed. Goldman Sachs, one of AIG’s major counterparties, has stated that it had adequate cash collateral to survive an AIG default.⁴ We need to be careful that “Too Big to Fail” does not become a self-fulfilling prophecy.

Clearly, the absolute size of an institution is not the predicate for systemic risk; it is rather the size of its debt, its derivatives positions, and the scope and complexity of many other financial relationships running between the firm, other institutions, and the wider financial system. As Senator Schumer’s example at Tuesday’s hearing illustrates, 50 small but highly correlated hedge funds might combine to create systemic risk. In short, the proper focus is on a bank’s interconnectedness with other financial institutions, and we have only a primitive understanding of the nature and extent of these connections. To the extent interconnectedness is a problem, the most fundamental way to attack it is to reduce the interconnections so that we can allow institutions to fail safely. This will also require that Federal regulators be given enhanced resolution authority, as set forth in H.R. 4173 and Senator Dodd’s Discussion Draft.⁵ And as Secretary Geithner recently acknowledged, “the Bankruptcy Code is not an effective tool for resolving the failure of a global financial services firm in times of severe economic stress.”⁶

To address our “Too Big to Fail Problem,” we need to modernize financial regulation to address the problems of today, not of the past.

Let me now turn in more depth to the Volcker Rules.

I. Proposed Restrictions on the Scope of Bank Operations

A. Proprietary Trading and “Too Big to Fail”

The Volcker Rules would prohibit banks and bank holding companies from engaging in proprietary trading “unrelated to serving customers for [their] own profit,” as well as from investing in or sponsoring hedge fund and private equity fund operations.⁷ Given that Mr. Volcker is the Chairman of the Trustees as well as the Chairman of the Steering Committee of the Group of 30 (G-30), it is worth noting that the Volcker Rules are significantly more aggressive than the G-30’s recent proposal to merely limit proprietary trading by “strict capital and liquidity requirements.”⁸

The objective embodied in the Volcker Rules is to restrict banks that are “Too Big to Fail” from participating in nontraditional risky investment activity, thus minimizing the chance they might fail and have to be rescued to avoid endangering uninsured depositors or the FDIC insurance fund. This might have been the concern in the past but it misses the mark today. The reason for the rescues during the crisis, such as AIG, or the TARP injections to forestall failures, was not to protect depositors of banks or the FDIC insurance fund. The reason was rather to avoid a chain reaction of failures set off by interconnectedness. Furthermore, this need for rescue does not depend on what activity gives rise to the potential bank failure. We will have to rescue banks whose failure will endanger other banks even if these fail-

⁴ Transcript of F3Q09 Earnings Call (David Viniar, Chief Fin. Officer, Goldman Sachs Group, Inc.) (Oct. 15, 2009).

⁵ H.R. 4173, 111th Cong. Subtitle G (2009); Restoring American Financial Stability Act, 111th Cong. Title II (2009) (mark by the Chairman of the S. Comm. on Banking, Housing and Urban Affairs).

⁶ Systemic Regulation, Prudential Matters, Resolution Authority and Securitization: Hearing Before the H. Comm. On Financial Services, 111th Cong. 2 (2009) (written testimony of Timothy F. Geithner).

⁷ Press Release, The White House, Remarks by the President on Financial Reform (Jan. 21, 2010), available at <http://www.whitehouse.gov/the-press-office/remarks-president-financial-reform>.

⁸ Group of 30, Financial Reform: A Framework for Financial Stability 8 (Jan. 15, 2009), <http://www.group30.org/pubs/recommendations.pdf>.

ing banks are engaging in traditional activities. Mr. Volcker seems to imply that it is acceptable to rescue banks engaging in traditional activities. I disagree. Quite frankly, I do not think a taxpayer would feel better about rescuing a bank that made risky loans than he would rescuing a bank that engaged in less traditional risky activity.

As a solution to the problem of “Too Big to Fail,” the Volcker Rules are over-inclusive because not all banks, and not even all large banks, pose chain-reaction risks to the financial system. The Rules are also potentially under-inclusive, because many interconnected financial institutions which do pose systemic risks are not deposit-taking banks. Goldman Sachs—which is the only U.S. bank with significant revenue exposure to proprietary trading⁹—could avoid falling under the Volcker Rules by divesting itself of its small deposit-taking operations, which account for only 5.19 percent of its liabilities.¹⁰ Similarly, Morgan Stanley would lose only 8.70 percent of its liability base by giving up bank holding company status.¹¹ None of the most prominent failures of the financial crisis—Fannie Mae, Freddie Mac, AIG, Bear Stearns, or Lehman Brothers—were deposit-taking banks.

Furthermore, major U.S. banks that do have high levels of deposits relative to total liabilities derive only a marginal fraction of their revenues from walled off proprietary trading activities, if “proprietary trading” is understood as trading activity carried out on internal trading desks purely for a bank’s own account. Wells Fargo and Bank of America, two of the largest deposit-funded banks, report deposits accounting for approximately 72 percent and 49 percent of their total liabilities, respectively, but are both estimated to earn less than 1 percent of revenues from proprietary trading.¹² These data show that U.S. banks with significant deposit bases assume little to no balance sheet risk from proprietary trading. Riskier institutions that do have exposure, if forced to choose between proprietary trading and deposits, may opt to “de-bank.” But because banks are highly regulated entities, regulators are in a good position to respond to bank failures. By encouraging banks to take themselves off the regulatory radar, the Volcker Rules could actually increase systemic risk. The regulatory and supervisory system is much better able to deal with controlling the risky activity of regulated banks than of unregulated investment banks, insurance companies, hedge funds, or commercial companies with large financial operations. The migration of risky bank activities to other large firms that may be “Too Big to Fail” would compound, rather than reduce, the systemic risk problem. The Administration’s earlier proposals envision some level of regulation of systemically important institutions other than banks, but such regulation will be much less comprehensive than it is for banks.

The original proposal was somewhat ambiguous as to the level of the banking organization at which the Rules would apply. Unless the Rules limit the activities of bank holding companies and all holding company subsidiaries, banks could evade the restrictions by shifting hedge fund or private equity investments and proprietary trading activities to nonbank subsidiaries. This would, perhaps, protect bank depositors, but it would not solve the need to rescue bank holding companies to avoid the chain-reaction-of-failures problem. Because proprietary trading, hedge fund, and private equity investments could pose the same threat to other financial institutions because of connectedness, regardless of whether they occur in a bank or its holding company, the Volcker Rules only make sense if they apply to bank holding companies and all of their subsidiaries (including banks and nonbanks).

B. What Is Proprietary Trading?

Mr. Volcker is confident that he as well as bankers know proprietary trading when they see it. Yet it is notable that neither Mr. Volcker nor the Treasury Department has presented a workable definition of this term. The suggestion that it

⁹ Goldman’s management has stated that proprietary trading accounts for 10 percent of its total revenues. Transcript of F4Q09 Earnings Call (David Viniar, Chief Fin. Officer, Goldman Sachs Group, Inc.) (Jan. 21, 2010). Citigroup reportedly maintains proprietary trading operations accounting for 5 percent of revenues. Jonathan Weisman, Damian Paletta and Robin Sidel, New Bank Rules Sink Stocks—Obama Proposal Would Restrict Risk-Taking by Biggest Firms as Battle Looms, *Wall St. J.*, Jan. 21, 2010, available at <http://online.wsj.com/article/SB10001424052748703699204575016983630045768.html>; Citigroup Inc., Quarterly Report (Form 10-Q), at 88 (Nov. 7, 2009).

¹⁰ See, Goldman Sachs Group, Inc., Quarterly Report (Form 10-Q), at 5 (Nov. 4, 2009).

¹¹ Morgan Stanley, Quarterly Report (Form 10-Q), at 2 (Nov. 9, 2009).

¹² See, Bank of America Corp., Quarterly Report (Form 10-Q), at 4 (Nov. 7, 2009); Wells Fargo and Co., Quarterly Report (Form 10-Q), at 63 (Nov. 7, 2009); Brooke Masters, “Alert Over Proprietary Trading Clamp”, *Fin. Times*, Jan. 28, 2010, available at <http://www.ft.com/cms/s/0/0293b842-0bab-11df-9f03-00144feabdc0.html>.

can be measured by a pattern of large gains and losses is unclear. Hedges or positions taken for customers can exhibit the same pattern.

Defining “proprietary trading” presents tremendous difficulties. Too narrow a definition, limited to discrete internal hedge fund and private equity activity undertaken by banks for their own accounts, is unlikely to lead to material reduction of risk, since these activities account for only a small fraction of most banks’ operations. Defining proprietary trading too broadly, meanwhile, might seriously impair the basic function of modern banks as market-makers in Government and non-government securities, and as securitizers of consumer debt. Neither of these options is very attractive.

1. *Proprietary Trading as “Internal Hedge Funds” Is Insignificant to Banks.*—Strictly construed, proprietary trading “unrelated to serving customers” encompasses any trading activity carried out on internal trading desks for a bank’s own account, but not on behalf of clients.¹³ Writing in the *New York Times* on Sunday, Mr. Volcker echoed this definition, identifying proprietary trading as “the search [for] speculative profit rather than in response to customer need.”¹⁴ Generally speaking, there are at least two reasons why this narrow definition of the activity is unlikely to reduce systemic risk. First, in absolute terms, the scale of such internal, noncustomer, proprietary trading is too negligible to drastically impact banks that engage in it. As outlined above, most U.S. banks, with the exception of Goldman Sachs, report minimal proprietary trading activity so defined.

Second, proprietary trading through internal hedge funds and other non-customer-related trading desks was not the source of the damaging losses that fatally impaired many of the banks at the center of the financial crisis. According to one Wall Street analyst’s estimate, of the approximately \$1.67 trillion of cumulative credit losses reported by U.S. banks, losses taken on trading activities and derivatives accounted for less than \$33 billion, or 2 percent, of this total.¹⁵ And as Bernstein Research notes in a recently published analysis, a construction of the Volcker Rules confined exclusively to internal hedge fund activity would not, for example, have reached the significant mortgage positions and unsecuritized loans held by Lehman Brothers that plummeted in value as liquidity drained from the market during the crisis. These positions, while proprietary, were not trading positions assumed by an internal trading desk for Lehman’s own account.¹⁶ Instead, they were accumulated as part of Lehman’s mortgage-underwriting and securitization businesses.

2. *Loan and Securitization Losses Were at the Heart of the Financial Crisis.*—The losses at the center of the financial crisis mainly resulted from the credit, lending, and securitization functions of U.S. banks. To date, the vast majority of overall credit losses—approximately 80 percent—have been linked to lending and securitization operations.¹⁷ Goldman Sachs estimates that approximately \$577 billion, or 34 percent, of cumulative losses were incurred by banks on direct real-estate-related lending, including mortgages, commercial real-estate loans, and construction lending. An additional \$338 billion of losses on non-real-estate loans accounted for 20 percent of cumulative losses. A further \$519 billion, or 31 percent, represented losses on indirect real-estate-backed securitizations, including RMBS, CMBS, and CDOs. The loss experiences of smaller regional banks, where poor-quality mortgage and construction loans drove the largest failures, confirm the centrality of credit and lending to bank losses. For example, option ARMs represented 65 percent of total loans at Downey Savings, 59 percent at BankUnited, 29 percent at Indymac, and 22 percent at Washington Mutual. Construction loans accounted for 88 percent of Corus Bank’s loan book.¹⁸ At regional U.S. banks, just as at the national and global levels, under-priced credit risk embedded in loans and securitized debt, and not speculative internal hedge funds, generated the lion’s share of the losses that led to financial collapse.

To be clear, portfolios of securitized debt instruments held on- and off-balance sheet by banks were responsible for roughly one-third of total credit losses. Broadening the definition of “proprietary trading” to restrict banks from holding securitized debt instruments might address one of the central risks banks were ex-

¹³ Bernstein Research, Quick Take—Thoughts About Proposed Trading Constraints and Investment Prohibitions 1 (Jan. 22, 2010).

¹⁴ Paul Volcker, “Op-Ed, How To Reform Our Financial System”, *N.Y. Times*, Jan. 31, 2010, available at <http://www.nytimes.com/2010/01/31/opinion/31volcker.html?hp>. (This article was attached to Mr. Volcker’s testimony on Feb. 2, 2010.)

¹⁵ Goldman Sachs Group, Inc., Goldman Investment Research, United States: Banks 6 (Nov. 30, 2009).

¹⁶ Bernstein Research, *supra* note 13, at 1.

¹⁷ Goldman Sachs Group, Inc., *supra* note 15.

¹⁸ *Id.* at 7.

posed to in the financial crisis. But do we really want to prevent banks from investing in securitized debt altogether? The question is complicated by the fact that owning securitized assets typically serves several purposes for banks, including making markets in securitized assets and assuring clients that the banks that structured their deals will have “skin in the game,” particularly by holding junior tranches of securitized debt.¹⁹ Indeed, recently adopted legislation in the European Union requires banks to retain a 5 percent interest in securitizations.²⁰ While it was also true that banks held securitized debt for speculative reasons, it would be difficult to separate such positions from those needed to engage in the securitization business. A blanket rule preventing banks from holding securitized debt might interfere with the revival of our already moribund securitized debt markets,²¹ since it would deprive banks of an important way of signaling the quality of issuances. Because restoring these markets is crucial to fueling new lending and economic growth²²—Mr. Volcker himself, in his opinion piece, cited the “large challenge in rebuilding an efficient, competitive private mortgage market, an area in which commercial bank participation is needed”²³—regulators must bear this risk in mind when implementing reforms.

3. Market-Making in Securities Is a Core Function of Banks.—In its most expansive formulation, proprietary trading could include any activity that places principal at risk, including the longstanding role that banks have played in modern capital markets as market-makers in U.S. Government, agency, and nongovernment securities. A rule which restricts the scope of this function by classifying market-making as a form of proprietary trading would reduce liquidity and increase borrowing costs throughout a wide range of securities markets, including the market for GSE and U.S. Treasury securities. This activity cannot easily be performed by other institutions—it requires the large balance sheets of banks.

According to Federal Reserve data cumulating securities ownership across all bank securities portfolios (including held-to-maturity, available for sale, and trading), over 60 percent of the securities held by banks are agency MBS and Treasuries.²⁴ Forced reductions in this inventory under the Volcker Rules would drain liquidity from important Government funding markets and entail higher borrowing costs for the U.S. Government and its sponsored entities, negatively impacting economic recovery.²⁵ Mr. Volcker likewise recognizes what he has called the “essential intermediating function” banks serve in meeting the “need for reliable sources of credit for businesses, individuals, and governments.”²⁶ And Glass-Steagall itself recognized the linkage between liquidity in Government debt markets and proprietary trading by banks in Government securities, providing for an exception authorizing banks to deal in, underwrite, and purchase for their own account securities issued

¹⁹ Morgan Stanley, Annual Report (Form 10-K), at 54 (Jan. 29, 2008) (for a discussion of these different roles of VIEs/SPVs in owning securitized assets).

²⁰ Regulations in the European Union permit “credit institutions” to have securitization exposures only if the “originator, sponsor or original lender” (a) retains no less than 5 percent of the nominal value of each of the tranches sold or transferred; (b) in the case of securitization of revolving exposures, retains of the originator’s interest no less than 5 percent of the nominal value of the securitized exposures; (c) retains randomly selected exposures, equivalent to less than 5 percent of the securitized exposures, where such exposures would otherwise have been securitized in the securitization, provided that the number of potentially securitized exposures is no less than 100 at origination; or (d) retains the first loss tranche, and if necessary, other tranches having the same or more severe risk profile than those transferred or sold to investors and not maturing any earlier than those transferred or sold to investors, so that retention equals in total no less than 5 percent of the nominal value of the securitized exposures. European Parliament and Council Directive 2009/111/EC, Sept. 16, 2009, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ.L:2009:302:0097:0119:EN:PDF>.

²¹ Data from the Securities Industry and Financial Markets Association show that there were approximately \$146 billion of asset backed securities issued in the U.S. in 2009, as compared to about \$754 billion when issuance of asset backed securities was at its peak in 2006. See, Sec. Indus. and Fin. Mkt. Ass’n, U.S. ABS Issuance, http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USABSIssuance.pdf.

²² Int’l Monetary Fund, Global Financial Stability Report 78 (Oct. 2009), available at <http://www.imf.org/external/pubs/ft/gfsr/2009/02/index.htm>.

²³ Volcker, *supra* note 14 (emphasis added).

²⁴ Fed. Res. Bd., Assets and Liabilities of Commercial Banks in the United States (Jan. 29, 2010), <http://www.federalreserve.gov/releases/h8/current/h8.pdf>.

²⁵ These portfolio breakdowns illustrate how banks manage cash through treasury operations on an ongoing basis by investing it in U.S. Treasuries, GSE securities, and other fixed-income securities in order to manage risk and improve their financial position. While treasury operations are largely fungible with running an “internal hedge fund,” they are an inevitable part of running a bank. This suggests that trying to prevent banks from running internal hedge funds may be an exercise in futility.

²⁶ Volcker, *supra* note 14 (emphasis added).

by the U.S. Government.²⁷ So the area which comprises the largest portion of bank trading, U.S. Government securities, would have to be preserved.

4. *Proprietary Trading Is a Source of Diversification for Banks.*—Portfolio diversification reduces risk. All else being equal, more concentrated portfolios are more volatile than portfolios containing an array of uncorrelated earnings streams, even when parts of the uncorrelated income are volatile. As the breakdowns discussed earlier illustrate, a substantial portion of bank losses sustained in the 2007–2008 financial crisis emanated from highly concentrated exposures to direct real-estate loans. And past financial crises, like the sovereign debt and thrift crises of the 1980s and the Asian crises of the 1990s, also involved lending operations. Proprietary trading (excluding securitization, as discussed earlier), which barely contributed to losses in these earlier periods, is a source of diversification that may help to mitigate, not aggravate, the risk profile of U.S. banks in the future. During the financial crisis, firms with significant proprietary trading operations like Goldman Sachs, or those that ran complex, interconnected books of business, including Goldman, Morgan Stanley, and JPMorgan, survived. Indeed, this diversification helped protect them in the crisis. By contrast, firms that concentrated their exposures in real-estate, like Lehman, or isolated these exposures in large, undercapitalized, off-balance sheet silos either did not survive, or needed Government capital injections to keep them afloat.

C. *Limitations on Private Equity and Hedge Fund Investing by Banks*

The Volcker Rules, in addition to limiting proprietary trading activity, would also restrict banks from owning, investing in, or sponsoring private equity funds (including venture capital funds whose activity is crucial to small business) and hedge funds.

Worldwide, banks and investment banks account for \$115 billion, or 12 percent, of the \$1.1 trillion of investment by limited partners including coinvestments in private equity funds involved in corporate finance and buyouts.²⁸ Indeed, banks are a larger source of capital as private equity limited partners than endowments or sovereign wealth funds.²⁹ Historically, banks have also represented an important source of direct proprietary involvement in private equity as general partners, raising an estimated \$80 billion in committed capital from investors over the past 5 years.³⁰ Mandating the exit of banks from involvement in these activities could force the withdrawal of a substantial fraction of the private equity industry's available investment capital. This would deal a disruptive blow to the recovery of the private equity industry on the heels of serious setbacks in terms of both fundraising and transaction activity which the industry sustained from 2007 to 2008. U.S. and global private equity fundraising activity remains at or below 2004 levels, with less than \$10 billion raised by U.S. funds in Q4 2009 as compared to an excess of \$100 billion raised in the same period in 2007.³¹ Nonetheless, private equity is still an important financing source for the U.S. economy, providing needed investment to undercapitalized or recapitalizing U.S. industries, including the financial sector. In Q4 2009, as investment activity began to recover, private equity funds invested \$8 billion in U.S. buyouts (executing \$48 billion in M and A transaction volume).³² At a moment when private equity activity is starting to rebound, rules that would force a withdrawal or reconfiguration of significant capital in the industry could chill investment in U.S. industry.

These prospective costs to the economy might be acceptable if they were offset by a commensurate reduction in bank balance sheet risk. But while bank investment is an important source of capital to private equity, it is not a meaningful proportion of bank assets.³³ As of September 30, 2009, investment in private equity accounted for less than 3 percent of the aggregate reported trading and/or "other" assets of the six largest U.S. banks. As a percentage of total bank assets, private equity in-

²⁷ 12 U.S.C. §24 (Seventh) provides that "[t]he limitations and restrictions herein contained as to dealing in, underwriting, and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof."

²⁸ Private Equity Council, *Private Equity and Banks* 1, Jan. 22, 2010; see also Press Release, Preqin, *Effects of Obama's Proposal on Alternatives Industry Significant* (Jan. 22, 2010), <http://www.preqin.com/docs/press/Preqin-PR-Potential-effects-of-Obamas-proposals-on-alternatives.pdf>.

²⁹ Private Equity Council, *supra* note 28, at 1.

³⁰ *Id.*

³¹ Private Equity Council, 2009 Year End Update 5-6, Jan. 4, 2010.

³² *Id.* at 2.

³³ Indeed, of the 10 largest private equity firms worldwide, only one—Goldman Sachs—is a U.S. bank. Bernstein Research, *supra* note 13, at 3.

vestments accounted for less than 1 percent of the total consolidated balance sheet of Bank of America, JPMorgan, Wells Fargo, and Citigroup, and less than 2 percent of the total balance sheet assets of Goldman Sachs and Morgan Stanley.³⁴ While relatively little bank capital is at risk in the private equity business, private equity nevertheless represents an important source of advisory, syndication, and underwriting revenues for banks which sponsor private equity funds.³⁵ Mandating the spin-off or closure of these funds would not improve the composition of bank balance sheets or the profile of bank riskiness, but would terminate a lucrative source of earnings at a time when banks are focused on recapitalizing.

Proprietary Investment in Private Equity as a Percentage of Trading and Other Assets (Q3 2009)³⁶ (\$ millions)

	Proprietary Investment in Private Equity	Trading and Other Assets	PE Investment % of Trading and Other Assets
Bank of America	\$13,500	\$280,000	4.8%
Goldman Sachs	\$12,480	\$381,000	3.3%
Morgan Stanley	\$8,500	\$340,000	2.5%
JPMorgan	\$6,836	\$351,000	1.9%
Wells Fargo	\$2,771	\$98,827	2.8%
Citigroup	\$359	\$118,000	0.3%
Total	\$44,446	\$1,568,827	2.8%

Although we have not been able to gather much data regarding bank exposure to the hedge fund industry,³⁷ the information we do have suggests that eliminating these activities will not significantly reduce bank risk profiles either. Analysis by Preqin shows that banks directly invest only \$10 billion (or 0.9 percent) of the total capital invested by U.S. investors in hedge funds.³⁸ In addition, banks have fund-of-funds units that are responsible for channeling \$180 billion (or 16 percent) of all U.S. capital flowing to hedge funds.³⁹ It is unclear what percentage of this \$180 billion represents banks' own capital. But even on the implausible assumption that all of \$180 billion comes from banks, it likely represents a negligible portion of bank risk.⁴⁰ It is far more likely that a significant portion of the \$180 billion is money that banks are managing on behalf of clients. Managing client funds (apart from the use of seed money) generally does not place bank capital at risk, and therefore does not implicate the underlying rationale of the Volcker Rules.⁴¹

In his written testimony, Deputy Secretary Wolin seemed to refer to Bear Stearns when he wrote that "[m]ajor firms saw their hedge funds and proprietary trading operations suffer large losses in the financial crisis. Some of these firms 'bailed out' their troubled hedge funds, depleting the firm's capital at precisely the moment it was most needed."⁴² Although Bear Stearns later pledged \$3.2 billion to bailout Bear Stearns High-Grade Structured Credit Fund and Bear Stearns High-Grade Structured Enhanced Leverage Fund, Bear's original principal exposure was only \$40 million. Clearly, Bear's real exposure, on a reputational basis, exceeded its in-

³⁴ Private Equity Council, *supra* note 28, at 1–8.

³⁵ Bernstein Research, *supra* note 13, at 3.

³⁶ Private Equity Council, *supra* note 28.

³⁷ This is a distinct topic from what we referred to in section I.B.1 as "internal hedge fund activity" at banks. The focus there was on trading activity carried out on internal trading desks that are for a bank's own account. Here, the focus is investments banks make directly, as limited or general partners, or indirectly, through funds of funds products, to hedge funds established as distinct legal entities. Some such hedge funds are managed by third-parties, while others are managed by bank affiliates.

³⁸ Preqin, *supra* note 28.

³⁹ *Id.*

⁴⁰ To provide a very rough sense of scale, as of September 2009, Goldman Sachs and JPMorgan held assets worth approximately \$882 billion and \$2.04 trillion, respectively. Goldman Sachs Group, Inc., Quarterly Report (Form 10-Q) (Nov. 4, 2009); JPMorgan Chase and Co., Quarterly Report (Form 10-Q) (Nov. 10, 2009).

⁴¹ Industry sources indicate that banks make small contributions of "seed money" to new funds to get them off the ground. Even if the Volcker Rules are enacted, the ability to make such contributions should be preserved through *de minimus* carveouts.

⁴² Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs, 111th Cong. 3 (Feb. 2, 2010) (statement of Neal S. Wolin, Deputy Secretary, U.S. Dept of the Treasury) [hereinafter Wolin Testimony].

vestment. The same was true for many banks' SIVs and conduits. This problem is best addressed by FASB's new consolidation accounting rules, FAS 166 and 167,⁴³ which effectively require banks to hold capital against these exposures. There is no need to ban these sponsorships entirely.

As the above analysis suggests, bank involvement with private equity and hedge funds can benefit bank customers in significant ways. Banks that sponsor or invest in private equity funds and hedge funds are better positioned to serve their global clients, who increasingly look to banks for "one-stop shopping" in financial products and services. Given the dramatic rise in assets under management in the private equity and hedge fund industry,⁴⁴ it is fair to infer that clients are particularly interested in these offerings. In addition, to the extent that banks are permitted to continue managing funds or fund-of-funds, allowing them to invest their own money alongside customers' is an important way to align interests.

Taking a more skeptical view of the implications for customers of bank involvement in proprietary trading as well as private equity funds and hedge funds, Mr. Volcker recently argued that these activities "present virtually insolvable conflicts of interest with customer relationships, conflicts that simply cannot be escaped by an elaboration of so-called 'Chinese walls' between different divisions of an institution."⁴⁵ Mr. Volcker elaborated on this point in his testimony before the Committee:

I want to note the strong conflicts of interest inherent in the participation of commercial banking organizations in proprietary or private investment activity. That is especially evident for banks conducting substantial investment management activities, in which they are acting explicitly or implicitly in a fiduciary capacity. When the bank itself is a "customer", *i.e.*, it is trading for its own account, it will almost inevitably find itself, consciously or inadvertently, acting at cross purposes to the interests of an unrelated commercial customer of a bank. "Inside" hedge funds and equity funds with outside partners may generate generous fees for the bank without the test of market pricing, and those same "inside" funds may be favored over outside competition in placing funds for clients. More generally, proprietary trading activity should not be able to profit from knowledge of customer trades.⁴⁶

If there is a sound justification for the Volcker Rules, it is that they would limit systemic risk, not that they would prevent conflicts of interest. Moreover, the issue of conflicts of interest was considered and rejected during the repeal of Glass-Steagall. If Mr. Volcker's contention were correct, it would be equally applicable to a much wider range of bank activities than proprietary trading and investment in hedge funds and private equity. It would extend to bank involvement in the underwriting of securities, for example, where the argument has long been made that a banker underwriting a faltering securities offering would encourage clients to invest in the securities.⁴⁷ Given that there is no proposal to limit bank underwriting, or other securities services that raise potential conflicts,⁴⁸ it is unclear why conflict of interest concerns justify restricting bank investments.

⁴³Fin. Accounting Standards Bd., Statement of Financial Accounting Standard 166, Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140 and Fin. Accounting Standards Bd., Statement of Financial Accounting Standards No. 167, Amendments to FASB Interpretation No. 46(R).

⁴⁴Private Equity Council, *supra* note 31, at 1–8; *Hedge Funds 2009* (Int'l Fin. Serv. London Research), Apr. 2009, <http://www.thehedgefundjournal.com/research/ifsl/cbs-hedge-funds-2009-2-.pdf>.

⁴⁵Volcker, *supra* note 14.

⁴⁶Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs, 111th Cong. (Feb. 2, 2010) (statement of Paul A. Volcker, Chairman, President's Economic Recovery Advisory Board) [hereinafter Volcker Testimony].

⁴⁷Joseph Michael Heppt, "An Alternative to Throwing Stones: A Proposal for the Reform of Glass-Steagall", 52 *Brook. L. Rev.* 281, 289 (1986).

⁴⁸In *Investment Company Institute v. Camp*, 401 U.S. 617 (1971), the Supreme Court discussed several additional conflicts that arise when commercial banking and securities services are combined. These include that banks involved in securities activities would: (a) lose the confidence of the public if their securities affiliates experienced business difficulties; (b) fail to act as "impartial sources of credit," giving preference to their securities affiliates or to borrowers that use securities services; (c) make unsound loans to their securities affiliates or to borrowers who use their securities services; (d) become unable to act as disinterested advisors to their commercial banking clients; and (e) divert talent and resources to their securities businesses.

II. Proposed Restrictions on the Size of Banks and other Financial Institutions

A. Proposed Limitations on the Size of Banks

The actual operation of the size limitations is even less clear than the meaning of the Volcker Rules on bank activity. The Administration has referred to “limits on the excessive growth of the market share of liabilities at the largest firms, to supplement existing caps on the market share of deposits.”⁴⁹ This appears to mean that the size limit would apply to banks’ market share of nondeposit liabilities.

Deputy Secretary Wolin’s recent testimony that the “size limit should not require existing firms to divest operations,” but will instead “serve as a constraint on future excessive consolidation among our major financial firms,” would appear to be addressed to market concentration and antitrust concerns since they carry the striking implication that no firm is currently “Too Big to Fail.”⁵⁰ If market concentration is the concern, we need to understand why existing antitrust law is not up to the task of dealing with this problem, while if systemic risk is the issue, it is puzzling why the size caps should apply only to firms that grow by acquisition. Presumably we should be concerned about the size (or the interconnectedness) of firms, whether the result of acquisition, organic growth, or otherwise.

To the extent systemic risk is the issue, the central questions are: (a) whether larger banks are more or less likely to fail than smaller banks; (b) whether the failure of large banks generates higher levels of systemic risk; and (c) whether the Administration’s proposal to cap each banks’ market share of liabilities is a plausible remedy for the problem.

If larger banks are riskier than smaller ones, the differences are likely to be relatively minor.⁵¹ Studies have found that large banks hold more diversified portfolios and are engaged in a wider range of business, and that such diversification serves as a source of strength.⁵² Scholars have also found that size promotes stability since it is easier for large banks to obtain funding in the capital markets.⁵³ On the other hand, larger banks tend to use size advantages to make riskier loans, conduct more off-balance sheet activities, and maintain more aggressive leverage ratios.⁵⁴ As banks grow larger, they may take on additional risk by becoming reliant on noninterest income and nondeposit funding.⁵⁵ On net, this combination of considerations may roughly balance out.

Turning to the second question, the surprising fact is that we do not know whether larger institutions pose greater systemic risk and, if so, whether that increase is significant. As discussed above, this question requires more data and discussion. The issue is whether larger banks are more interconnected in such a way that their failure would set off a chain reaction of failures. This should not be accepted on faith.

To the extent that systemic risk does increase with “size,” it is unclear that broad-brush restrictions on nondeposit liabilities are the solution. First, the focus on liabilities ignores the fact that a bank’s riskiness is determined in large part by the assets it holds. Some of the most prominent victims of the financial crisis failed because of the interactions between different parts of their balance sheets (*e.g.*, funding risky assets with overnight loans). Second, a bank could comply with the general liability restrictions while maintaining risky assets. The Volcker Rules would not limit the ability of banks to make risky loans. Thus, the somewhat smaller bank, faced with Volcker Rules and size caps, may shift its activity to overall higher levels of risk in search of return. As Raghuram Rajan, Professor of Finance at the University of Chicago and author of a prescient paper anticipating the financial crisis,⁵⁶ recently wrote:

⁴⁹The White House, *supra* note 7.

⁵⁰Wolin Testimony, *supra* note 42, at 4.

⁵¹Rebecca Demsetz and Philip Strahan, “Historical Patterns and Recent Changes in the Relationship Between Bank Holding Company Size and Risk”, 1 *Econ. Pol. Rev.* 13 (July 1995); see also Rebecca Demsetz and Philip Strahan, “Diversification, Size, and Risk at Bank Holding Companies”, 29 *J. Money, Credit, and Banking* 300, 308 (1997).

⁵²*See, e.g.*, Rebecca Demsetz and Philip Strahan, “Diversification, Size, and Risk at Bank Holding Companies”, 29 *J. Money, Credit, and Banking* 300 (1997).

⁵³Jith Jayaratne and Donald P. Morgan, “Capital Market Frictions and Deposit Constraints at Banks”, 32 *J. Money, Credit, and Banking* 74 (2000).

⁵⁴*See, e.g.*, Demsetz and Strahan, *supra* note 52, at 312.

⁵⁵Asli Demirguc-Kunt and Harry Huizinga, “Bank Activity and Funding Strategies: The Impact on Risk and Return” 29 (European Banking Center Discussion Paper No. 2009-01, 2009).

⁵⁶*See*, Raghuram G. Rajan, Fed. Res. Brd. of K.C., “Has Financial Development Made The World Riskier?” (2005), <http://www.kc.frb.org/publicat/SYMPOS/2005/PDF/Rajan2005.pdf>.

Crude asset size limits, for example, would probably ensure a lot of financial activity is hidden from the regulator, only to come back to light (and to the balance sheets) at the worst of times. There are many legal ways to mask size. Banks can offer guarantees to assets placed in off-balance sheet vehicles, much like the conduits of the recent crisis. If, instead, capital is the measure, then we will be pushing banks to economize on it as much as possible, hardly a recipe for safety.⁵⁷

Finally, we should consider if overall size limitations are preferable to an approach targeted at individual institutions. It appears that, at most, only six banking institutions would be impacted. Assuming, for example, that a 10 percent of domestic wholesale funding market share ceiling is imposed on U.S. banks—analogueous to the deposit market share limits already in place—Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, and Morgan Stanley are the only institutions that appear to approach this ceiling level.⁵⁸ If a higher ceiling than 10 percent wholesale funding market share is imposed, it is possible that only the very largest domestic users of wholesale funding—Bank of America and JPMorgan Chase, the only two institutions with wholesale funding market shares significantly greater than 10 percent—would be impacted. We note that beyond these six institutions, the U.S. bank wholesale funding market is highly fragmented; no other institution has more than a 3 percent market share. Given that the size limitations might affect only a handful of banks, a better policy would be to address issues at those banks individually through better and more intense supervision.

We must also take into account that size limitations on our biggest banks will negatively affect their global competitiveness.⁵⁹ Size limitations could cause U.S. banks to lose the business of their largest and most important customers, who will prefer to work with banks that have the capacity to address their global needs. Larger banks and their customers also benefit from the economies of size and scope that exist when banks are large enough to offer a wider range of products, such as lending and derivatives. One study by an economist at the New York Federal Reserve found that bank productivity grew more than 0.4 percent per year during the bank merger wave of the early 1990s,⁶⁰ while Charles Calomiris of Columbia Business School suggests that the increasing size of banks has lowered underwriting costs associated with accessing public equity markets by as much as 20 percent.⁶¹ As it is, as of the end of 2008, the United States only had two of the 10 largest banks in the world, Bank of America (6th) and JPMorgan Chase (9th).⁶² The world's five biggest banks are BNP Paribas (France), Royal Bank of Scotland (U.K.), Barclays (U.K.), Deutsche Bank (Germany), and HSBC (U.K.).

In this connection, it is worth recalling that a major motivation for the decision to repeal Glass-Steagall was the need to increase the competitiveness of U.S. financial institutions.⁶³ At the time, Senator Proxmire noted that Glass Steagall's "restrictions inhibit a U.S.-based firm from offering the entire range of financial services to both domestic and foreign customers in the United States."⁶⁴ Therefore, many U.S. and foreign financial institutions were choosing to locate offshore, where

⁵⁷ Raghuram Rajan, Op-Ed., "A better way to reduce financial sector risk", *Fin. Times*, Jan. 25, 2010.

⁵⁸ This judgment is subject to some measurement error due to the difficulty of determining the precise domicile of particular wholesale funding sources. Apart from defining what types of nondeposit liabilities count as wholesale funding, the specific data issue that arises in determining U.S. wholesale funding market shares relates to determining sources of wholesale funding. While the Federal Reserve reports wholesale funding data for the U.S. banking system as a whole (see, Bd. of Gov. of the Fed. Res., *Assets and Liabilities of Commercial Banks in the United States* (Jan. 29, 2010), available at <http://www.federalreserve.gov/releases/h8/current/default.htm#fn21>), individual banks with significant international operations (i.e., the six institutions mentioned above) generally do not disclose what portions of their nondeposit funding come from U.S. versus international sources. Thus determining the U.S.-only wholesale funding market shares for these institutions requires making some estimates about the proportion of wholesale funding that comes from the United States.

⁵⁹ Charles Calomiris, Op-Ed., "In the World of Banks, Bigger Can Be Better", *Wall St. J.*, Oct. 19, 2009.

⁶⁰ Kevin J. Stiroh, "How did bank holding companies prosper in the 1990s?", *24 J. Banking and Fin.* 1703 (Nov. 2000).

⁶¹ Calomiris, *supra* note 59.

⁶² Data from Capital IQ as reported in Damian Paletta and Alessandra Galloni, Europe, U.S. Spar on Cure for Banks, *Wall St. J.*, Sept. 23, 2009, available at <http://online.wsj.com/article/SB125366282157932323.html>.

⁶³ Comm. on Capital Mkts. Reg., *supra* note 1.

⁶⁴ 134 Cong. Rec. S3,382 (1988) (statement of Sen. Proxmire).

they could provide such products to foreign clients.⁶⁵ Furthermore, although U.S. banks had expertise as underwriters through offshore activity, they could not achieve the economies of scale attainable through underwriting domestically.⁶⁶ Any limitation on U.S. bank activities that did not extend to foreign banks would be damaging to their future profitability.

B. Proposed Limitations on the Size of Other Financial Institutions

To the extent that the proposed rules regarding nondeposit liability market share addresses financial institutions other than bank holding companies, it is important to consider the potential impact on four additional groups. First, there are a number of U.S. wholesale-funded lending businesses—most notably credit card lenders and nonbank commercial lenders—that are not typically grouped with banks in regulatory discussions. Many of the largest of these lending businesses are subsidiaries of bank holding companies. Of those that are not bank holding company subsidiaries, although some are large within the context of their narrowly defined business segments (credit carding lending, *etc.*), even the largest have modestly sized wholesale funding bases compared to the largest bank holding companies. In credit cards, for example, American Express and Capital One Financial (the largest pure-play card lenders by wholesale liabilities) have only 3 percent and 1 percent wholesale funding market shares, respectively.⁶⁷ Similarly, GMAC and CIT, the largest wholesale-funded commercial lending businesses have only 4.5 percent and 2.2 percent nondeposit liability market shares, respectively.⁶⁸ Though the precise details on the proposed wholesale funding limits are not yet available, it is hard to imagine that the market share ceiling would be set low enough to impact even the largest of these lenders.

Second, a number of U.S. insurance companies also have sizable balance sheets, with ostensibly sizable nondeposit liability bases. Although these large liability bases may seem to place insurers within the purview of the proposed liability size restrictions, the size caps are unlikely to apply to these institutions for two reasons: (1) insurers in general simply do not rely heavily on wholesale funding as part of their business models—the majority of the large funding bases of these institutions consists of expected future benefits or actuarial estimates of unpaid claims (classic insurance “float” funding that appears to fall outside the definition of the funding targets)⁶⁹ and (2) as the last crisis has shown, the riskiest insurance institutions, like AIG, suffered primarily from underwriting risk—much of which was opaquely held in off-balance sheet vehicles—not from funding risk *per se*.

Third, there are money market mutual funds that as of the week ended January 27, had assets totaling \$3.218 trillion.⁷⁰ The five largest money market fund families managed roughly 15 percent (Fidelity), 11 percent (JPMorgan), 8 percent (Federated), 7 percent (Blackrock) and 6 percent (Dreyfus) of this amount.⁷¹ Since even the largest money market fund family does not have a dominant share of the market, and there are numerous fund families with substantial levels of assets under management, the case for capping the size of money market mutual funds based purely on market concentration of liabilities appears weak.

Fourth, though GSEs are not bank holding companies, the largest GSEs use sufficient wholesale funding to make them worth discussing here. Freddie Mac and Fannie Mae each have roughly \$800 billion in wholesale funding, an amount that dwarfs the domestic wholesale funding requirements of all bank holding companies, except that of Bank of America whose wholesale funding is slightly over \$1 trillion.⁷² Given these very large nondeposit liability requirements—together these two

⁶⁵ *Id.* at S3,385 and S3,382.

⁶⁶ *Id.* at S3,382.

⁶⁷ See, American Express, Financial Supplements (Q4 2009) and Capital One, Financial Supplements (Q4 2009).

⁶⁸ See, GMAC, Quarterly Report (Form 10-Q) (Nov. 4, 2009) and CIT, Quarterly Report (Form 10-Q) (Nov. 7, 2009). Note that even before its bankruptcy, at the end of 2008, CIT's nondeposit liability market share was only slightly higher, at 2.5 percent.

⁶⁹ As examples, consider leading insurer Metlife's balance sheet—though its liability base is roughly 70 percent of Morgan Stanley's, its wholesale funding base is only 10 percent of Morgan Stanley's. Put differently, if Metlife were a bank holding company it would have a U.S. nondeposit liability funding market share of only about 2 percent. See, Metlife, Quarterly Report (Form 10-Q) (Nov. 4, 2009) and Morgan Stanley, Financial Supplement (Q4 2009).

⁷⁰ Inv. Co. Inst., Money Market Mutual Fund Assets (Jan. 28, 2010), available at http://www.ici.org/research/stats/mmf/mm_01_28_10.

⁷¹ Crane Data, Largest Money Fund Managers, Dec. 21, 2009, available at <http://www.cranedata.us>.

⁷² See, Freddie Mac, Quarterly Report (Form 10-Q) (Nov. 6, 2009); Fannie Mae, Quarterly Report (Form 10-Q) (Nov. 5, 2009); Bank of America Corp., Quarterly Report (Form 10-Q), at 4 (Nov. 7, 2009).

GSEs use more wholesale funding than half of the entire U.S. bank holding company total—excluding them from any new size restrictions would seem highly inconsistent with the treatment of banks.

In concluding the discussion of liability size restrictions, it is important to keep in mind that regardless of the liability size of any bank or nonbank financial institution, the proposed rules fail to address the more fundamental issue that nondeposit liability market share is not a good proxy for an institution's broader systemic risk. Even if a commercial lender or an insurer does not rely on systemically large amounts of wholesale funding, the interconnectedness of these and similar institutions could ultimately make them "Too Big to Fail." Any set of new regulations designed to reduce systemic risk must focus not just on the size of institutions' wholesale liabilities, but also on institutions' connections with the broader financial system.

III. There Has Been a Lack of International Coordination in the Newest Proposals

Up to this point, the Obama administration wisely and appropriately has been careful to coordinate its regulatory reform recommendations with international efforts. In the Treasury White Paper, the Administration stressed the importance of international coordination stating, "The United States is playing a strong leadership role in efforts to coordinate international financial policy through the G-20, the Financial Stability Board, and the Basel Committee on Banking Supervision. We will use our leadership position in the international community to promote initiatives compatible with . . . [U.S.] domestic regulatory reforms."⁷³ Regrettably, this has not been the case with the Volcker Rules or size limitations.

Based on the initial reaction from international financial and regulatory bodies, we are far from reaching consensus on this issue. Speaking at the Davos economic summit, Dominique Strauss-Kahn—head of the International Monetary Fund—highlighted the lack of international cooperation behind President Obama's proposed banking reforms saying, "The question of coordinating the financial reform is key and I'm afraid we're not going in that direction."⁷⁴ The Financial Stability Board says that the proposals are "amongst the range of options and approaches under consideration" and that a "mix of approaches will be necessary to address the ['Too Big to Fail'] problem,"⁷⁵ hardly an endorsement. And earlier this week, the Deputy Director-General of the European Commission's internal market and services division, David Wright, said he was surprised the U.S. had taken a radical line on the structure of banking without first consulting European leaders—especially in light of U.S. discontent last year when the European Commission took the lead on securitization and credit rating agency reforms.⁷⁶ Wright added that it might be difficult to find the right definition of "proprietary trading" to satisfy the Obama administration's goals without inflicting unintended consequences on the industry, emphasizing that Europe traditionally prefers to reform processes rather than change bank structure.⁷⁷

National leaders have also emphasized the need for a coordinated approach. French President Nicolas Sarkozy stressed that all regulation concerning banks should be dealt with at an international level, coordinated by the G-20.⁷⁸ Sarkozy called the current crisis a "crisis of globalization itself," urging broad coordination of regulation and accounting rules.⁷⁹ In Germany, the Finance Ministry merely referred to the President's proposals as "helpful suggestions," with Chancellor Angela Merkel stating that her Government will offer its own proposal to prevent G-20 banks from getting too big or interconnected.⁸⁰

As Mr. Volcker asserted in his testimony before this Committee on Tuesday:

⁷³Treasury White Paper, *supra* note 2, at 80.

⁷⁴Simon Carswell, "IMF Head Calls for Financial Reform", *Irish Times*, Jan. 30, 2010, available at <http://www.irishtimes.com/newspaper/breaking/2010/0130/breaking13.htm>.

⁷⁵Press Release, Fin. Stability Bd., "FSB Welcomes U.S. Proposals for Reducing Moral Hazard Risks" (Jan. 22, 2010), http://www.financialstabilityboard.org/press/pr_100122.pdf.

⁷⁶Joel Clark, "EC Says Obama Prop Trading Plans Would Be 'Difficult' to Implement", *Risk Magazine*, Feb. 1, 2010, available at <http://www.risk.net/risk-magazine/news/1589763/ec-obama-prop-trading-plans-difficult-implement>.

⁷⁷*Id.*

⁷⁸Katrin Benhold, At Davos, Sarkozy Calls for Global Finance Rules, *N.Y. Times*, Jan. 27, 2010, available at <http://www.nytimes.com/2010/01/28/business/global/28davos.html>.

⁷⁹*Id.*

⁸⁰Andrea Thomas, 2nd Update: Germany: Need International Review of Obama Plan, *Wall St. J.*, Jan. 22, 2010, available at <http://online.wsj.com/article/BT-CO-20100122705666.html?mod=WSJ-World-MIDDLEHeadlinesEurope>.

A strong international consensus on the proposed approach would be appropriate, particularly across those few nations hosting large multinational banks and active financial markets. The needed consensus remains to be tested. However, judging from what we know and read about the attitude of a number of responsible officials and commentators, I believe there are substantial grounds to anticipate success as the approach is fully understood.⁸¹

In his appearance before the Committee, Mr. Volcker added that London was the other financial center whose acceptance of the Volcker Rules would be critical. Yet Prime Minister Gordon Brown of the United Kingdom, while welcoming the suggestion, stated the U.K. should consider similar rules only if there is an international agreement.⁸² The U.K.'s Chancellor of the Exchequer, Alistair Darling, expressed concerns that separating banks does not solve the problem posed by interconnectivity.⁸³ To the extent there is a solution, he noted that "everything we do has to be a global solution otherwise we will get arbitrage."⁸⁴ Such comments are anything but an endorsement.

IV. The Perlmutter-Miller and Kanjorski Amendments Suggest a Preferable Approach

If Congress were to conclude that bank activities and the size of financial companies were a problem, the Perlmutter-Miller and the Kanjorski Amendments to the House Bill are better solutions than the Volcker Rules and size limitations.

The Perlmutter-Miller Amendment would allow the Federal Reserve Board (Board) to prohibit a systemically important financial holding company that is subject to stricter prudential supervision from engaging in all proprietary trading activities when the Board finds that trading activities threaten the safety and soundness of such company or of the U.S. financial system.⁸⁵ The Amendment defines "proprietary trading" broadly, as "trading of stocks, bonds, options, commodities, derivatives, or other financial instruments with the company's own money and for the company's own account."⁸⁶ However, the Board has the flexibility to ban certain forms of proprietary trading at a company without putting an end to all of company's proprietary trading activities. Instead, the Board can exempt proprietary trading activities that are "ancillary to other operations of the company" and do not pose a threat to the company or U.S. financial stability, provided they are carried on for the purpose of making a market in securities issued by the company, hedging or managing risk or other purposes permitted by the Board.⁸⁷ While it would be preferable to extend this exemption to market making in a broader range of securities, allowing the Board to address proprietary trading at individual institutions and to distinguish between different trading activities is a better approach than the Volcker Rules.

If the Perlmutter-Miller Amendment is a better way of addressing proprietary trading, the Kanjorski Amendment is a better solution to the broader problem of all activities and size.⁸⁸ The Kanjorski Amendment would allow a new Financial Services Oversight Council to require "mitigatory actions" whenever an individual firm that has been subject to stricter prudential supervision is deemed to pose a "grave threat to the financial stability or economy of the United States."⁸⁹ The Amendment anticipates that such a threat could arise from a wide range of sources—including the amount and nature of a company's financial assets and liabilities, off-balance sheet exposures, reliance on leverage, interconnectedness with other firms, the company's importance as a source of credit for households and businesses and the scope of its activities.⁹⁰ It considers a wide range of remedies: requiring the institutions to terminate one or more of its activities; restricting its ability to offer financial products; and requiring the firm to sell, divest or otherwise

⁸¹ Volcker Testimony, *supra* note 46.

⁸² Terence Roth and Laurence Norman, Europe Divided of U.S. Bank Proposal, Seeks global Pact, *Wall St. J.*, Jan. 22, 2010, available at <http://online.wsj.com/article/SB10001424052748704509704575018622712047044.html?mod=WSJ-Markets-LEFTTopNews>.

⁸³ Philip Aldrick, Alistair Darling Dismisses Obama's Plan to Break Up Banks as Ineffective, *Telegraph*, Jan. 28, 2010, available at <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/7093796/Alistair-Darling-dismisses-Obama-plan-to-break-up-banks-as-ineffective.html>.

⁸⁴ *Id.*

⁸⁵ H.R. 4173, 111th Cong. §1117(a) (2009).

⁸⁶ *Id.* §1117(e).

⁸⁷ *Id.* §1117(b).

⁸⁸ *Id.* §1105.

⁸⁹ *Id.* §1105(a).

⁹⁰ *Id.* §1105(c).

transfer business units, branches, assets or off balance sheet items.⁹¹ Firms that are subject to mitigatory actions have the right to a hearing⁹² and can seek judicial review if such actions are imposed on an arbitrary or capricious basis.⁹³

I am not endorsing these amendments but do believe they are preferable to the Volcker Rules and size limitations.

Thank you and I look forward to your questions.

PREPARED STATEMENT OF BARRY L. ZUBROW

CHIEF RISK OFFICER AND EXECUTIVE VICE PRESIDENT, JPMORGAN CHASE AND CO.

FEBRUARY 4, 2010

Good morning Chairman Dodd, Ranking Member Shelby, Members of the Committee. My name is Barry Zubrow, and I am the Chief Risk Officer and Executive Vice President of JPMorgan Chase and Co. Thank you for the opportunity to appear before the Committee today to discuss the Administration's recent proposals to limit the size and scope of activities of financial firms.

While the history of the financial crisis has yet to be written conclusively, we know enough about the causes—poor underwriting, too much leverage, weak risk management, excessive reliance on short-term funding, and regulatory gaps—to recognize that we need substantial reform and modernization of the regulatory structure for financial firms. Our current framework was patched together over many decades; when it was tested, we saw its flaws all too clearly.

We at JPMorgan Chase strongly support your efforts to craft and pass meaningful regulatory reform legislation that will provide clear, consistent rules for our industry. It is our view that the markets and the economy reflect continued uncertainty about the regulatory environment. I believe that economic recovery would be fostered by passage of a bill that charts a course for strong, responsible economic leadership from U.S. financial institutions. However, the details matter a great deal, and a bill that creates uncertainty or undermines the competitiveness of the U.S. financial sector will not serve our shared goal of a strong, stable economy.

At a minimum, reform should establish a systemic regulator responsible for monitoring risk across our financial system. Let me be clear that responsibility for a company's actions rests solely with the company's management. However, had a systemic regulator been in place and closely watching the mortgage industry, it might have identified the unregulated pieces of the mortgage industry as a critical point of failure. It might also have been in a position to recognize the one-sided credit derivative exposures of AIG and the monoline insurers. While it may be unrealistic to believe that a systemic regulator could prevent future problems entirely, such a regulator may be able to mitigate the consequences of some failures and prevent them from collectively becoming catastrophic.

As we at JPMorgan Chase have stated repeatedly, no firm—including our own—should be too big to fail. The goal is to regulate financial firms so they don't fail; but when they run into trouble, all firms should be allowed to fail, regardless of their size or interconnections to other firms.

To ensure that this can happen—especially in times of crisis—regulators need enhanced resolution authority to wind down failing firms in a controlled way that does not put taxpayers or the broader economy at risk. Such authority can be an effective mechanism that makes it absolutely clear that there is no financial safety net for managements or shareholders.

Under such a system, a failed bank's shareholders should lose their investments; unsecured creditors should be at risk and, if necessary, wiped out. A regulator should be able to terminate management and boards and liquidate assets. Those who benefited from mismanaging risks or taking on inappropriate risk should feel the pain. Other aspects of the regulatory system also need to be strengthened—including consumer protection, capital standards and the oversight of the OTC derivatives market—but I emphasize systemic risk regulation and resolution authority specifically because they provide a useful framework for consideration of the most recent proposals from the Administration.

Restrictions on Proprietary Trading and Bank Ownership of Private Equity and Hedge Funds

Two weeks ago, the Administration proposed new restrictions on financial firms. The first would prohibit banks from “owning, investing in or sponsoring a hedge

⁹¹ *Id.* §1105(d)(1).

⁹² *Id.* §1105(e)(1).

⁹³ *Id.* §1105(h).

fund or a private equity fund, or proprietary trading operations” that are not related to serving customers. The new proposals are a divergence from the hard work being done by legislators, central banks and regulators around the world to address the root causes of the financial crisis and establish robust mechanisms to properly regulate systemically important financial institutions.

While there may be valid reasons to examine these activities, there should be no misunderstanding: the activities the Administration proposes to restrict did not cause the financial crisis. In no case were bank-held deposits threatened by any of these activities. Indeed, in many cases, those activities diversified financial institutions’ revenue streams and served as a source of stability. The firms that failed did so largely as a result of traditional lending and real estate-related activities. The failures of Wachovia, Washington Mutual, Countrywide, and IndyMac were due to defaulting subprime mortgages. Bear Stearns, Lehman, and Merrill Lynch were all damaged by their excessive exposure to real estate credit risk.

Further, regulators currently have the authority to ensure that risks are adequately managed in the areas the Administration proposes to restrict. Regulators and capital standards-setting bodies are empowered, and must utilize those powers, to ensure that financial companies of all types are appropriately capitalized at the holding company level (as we are at JPMorgan Chase).

While bank holding companies may engage in proprietary trading and own hedge funds or private equity firms, comprehensive rules are in place that severely restrict the extent to which insured deposits may finance these activities. And regulators have the authority to examine all of these activities. Indeed, existing U.S. rules require that firms increase the amount of capital they hold as their private equity investments increase as a percentage of capital, effectively restraining their private equity portfolios.

While regulators have the tools they need to address these activities in bank holding companies, we need to take the next logical step of extending these authorities to all systemically important firms regardless of their legal structure. If the last 2 years have taught us anything, it is that threats to our financial system can and do originate in nondepository institutions. Thus, any new regulatory framework should reach all systemically important entities—including investment banks—whether or not they have insured deposit-based business; all systemically important institutions should be regulated to the same rigorous standard. If we leave outside the scope of rigorous regulation those institutions that are interconnected and integral to the provision of credit, capital and liquidity in our system, we will be right back where we were before this crisis began. We will return to the same regime in which Bear Stearns and Lehman Brothers both failed and other systemically important institutions nearly brought the system to its knees. We cannot have two tiers of regulation for systemically important firms.

As I noted at the outset, it is also very important that we get the details right. Thus far, the Administration has offered few details on what is meant by “proprietary trading.” Some traditional bank holding company activities, including real estate and corporate lending, expose these companies to risks that have to be managed by trading desks. Any individual trade, taken in isolation, might appear to be “proprietary trading,” but in fact is part of the mosaic of serving clients and properly managing the firm’s risks. Restricting activities that could loosely be defined as proprietary trading would reduce the safety and soundness of our banking institutions, raise the cost of capital formation, and restrict the availability of credit for businesses, large and small—with no commensurate benefit in reduced systemic risk.

Similarly, the Administration has yet to define “ownership or sponsorship” of hedge fund and private equity activities. Asset managers, including JPMorgan Chase, serve a broad range of clients, including individuals, universities, and pensions, and need to offer these investors a broad range of investment opportunities in all types of asset classes. In each case, investments are designed to meet the specific needs of the client.

Our capital markets rely upon diversified financial firms equipped to meet a wide range of financing needs for companies of all sizes and at all stages of maturity, and the manner in which these firms are provided financing is continually evolving in response to market demand. Codifying strict statutory rules about which firms can participate will distort the market for these services—and result in more and more activities taking place outside the scope of regulatory scrutiny. Rather, Congress should mandate strong capital and liquidity standards, give regulators the authority they need to supervise these firms and activities, and conduct rigorous oversight to ensure accountability.

While we agree that the United States must show leadership in regulating financial firms, if we take an approach that is out of sync with other major countries

around the world without demonstrable risk-reduction benefits, we will dramatically weaken our financial institutions' ability to be competitive and serve the needs of our clients. Asset management firms (including hedge funds and private investment firms) play a very important role in today's capital markets, helping to allocate capital between providers and users. The concept of arbitrarily separating different elements of the capital formation process appears to be under consideration only in the U.S. Forcing our most competitive financial firms to divest themselves of these business lines will make them less competitive globally, allowing foreign firms to step in to attract the capital and talent now involved in these activities. Foreign banks will gain when U.S. banks cede the field.

Concentration Limits

The second of the recent Administration proposals would limit the size of financial firms by "growth in market share of liabilities." Again, while the Administration has not provided much detail, the proposal appears to be based on the assumption that the size of financial firms or concentration within the financial sector contributed to the crisis.

If you consider the institutions that failed during the crisis, some of the largest and most consequential failures were stand-alone investment banks, mortgage companies, thrifts, and insurance companies—not the diversified financial firms that presumably are the target of this proposal. It was not AIG's and Bear Stearns' size but their interconnection to other firms that prompted the Government to step in. In fact, JPMC's capabilities, size, and diversity were essential to our withstanding the crisis and emerging as a stronger firm—and put us in a position to acquire Bear Stearns and Washington Mutual when the Government asked us to. Had we not been able to purchase these companies, the crisis would have been far worse.

With regard to concentration specifically, it is important to note that the U.S. financial system is much less concentrated than the systems of most other developed nations. Our system is the 2nd least concentrated among OECD countries, just behind Luxembourg; the top 3 banks in the U.S. held 34 percent of banking assets in 2007 *vs.* an average for the rest of the OECD of 69 percent.

An artificial cap on liabilities will likely have significant negative consequences. For the most part, banks' liabilities and capital support the asset growth of its loan and lending activities. By artificially capping liabilities, banks may be incented to reduce the growth of assets or the size of their existing balance sheet, which in turn would restrict their ability to make loans to consumers and businesses, as well as to invest in Government debt. Capping the scale and scope of healthy financial firms cedes competitive ground to foreign firms and to less regulated, nonbank financial firms—which will make it more difficult for regulators to monitor systemic risk. It would likely come at the expense of economic growth at home. No other country in the world has a Glass-Steagall regime or the constraints recently proposed by the Administration, nor does any country appear interested in adopting one. International bodies have long declined to embrace such constraints as an approach to regulatory reform.

Conclusion

We have consistently endorsed the need for meaningful regulatory reform and have worked hard to provide the Committee and others with information and data to advance such reform. We agree that it is critically important to eliminate any implicit financial "safety net" by assuring appropriate capital standards, risk management and regulatory oversight on a consistent and cohesive basis for all financial firms, and, ultimately, having a robust regime that allows any firm to fail if it is mismanaged.

While numerical limits and strict rules may sound simple, there is great potential that they would undermine the goals of economic stability, growth, and job creation that policymakers are trying to promote. The better solution is modernization of our financial regulatory regime that gives regulators the authority and resources they need to do the rigorous oversight involved in examining a firm's balance sheet and lending practices. Effective examination allows regulators to understand the risks institutions are taking and how those risks are likely to change under different economic scenarios.

It is vital that policymakers and those with a stake in our financial system work together to overhaul our regulatory structure thoughtfully and well. Clearly such work needs to be done in harmony with other countries around the world. While the specific changes required by reform may seem arcane and technical, they are critical to the future of our whole economy. We look forward to working with the Committee to enact the reforms that will position our financial industry and economy as a whole for sustained growth for decades to come.

Thank you.