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Testimony of Daniel Tarullo

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Hearing: Strengthening and Streamlining Prudential Bank Supervision

August 4, 2009

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

Thank you, Mr. Chairman, Ranking Member Shelby, and other members of the committee.

Before the final history of the financial crisis is written, I'm certain that supervisory shortcomings in all kinds and sizes of institutions -- financial institutions will have been revealed.

The crisis has also shown that the framework for prudential supervision and regulation has not kept pace with changes in the structure, activities and interrelationships of the financial sector. In my prepared testimony, I have suggested and tried to elaborate the elements of an effective framework for prudential supervision, including a number of recommendations for legislative action.

Knowing of your time constraints this morning, let me confine these introductory remarks to three quick points.

First, prudential supervision must be required for all systemically important institutions. It is noteworthy that a number of the firms at the heart of the crisis had not been subject to mandatory prudential supervision of any sort. Improving the quality of supervision will fall short of realizing the maximum potential gains for financial stability if important institutions can escape the rules and requirements associated with the supervisory process.

Second, there must be effective supervision of the companies that own insured depository institutions, a task that is distinct from the supervision of the banks themselves. Large organizations increasingly manage their businesses on an integrated basis with little regard for the corporate boundaries that typically define the jurisdiction of individual functional supervisors. There is need for close scrutiny of the linkages between the banks and other affiliates within a holding company, not just straightforward financial or contractual ties, but also managerial, operational and reputational linkages. The premise of so-called functional regulation, that risks within a diversified organization can be successfully evaluated and controlled through supervision within each individual firm, has been belied by the experience of the financial crisis.

Third, it is important to emphasize that much of what needs to be done to improve and adapt our system of prudential supervision lies within the existing authorities of the agencies represented at this table. Together, we have acted to shut down the practice of converting charters in order to escape enforcement actions or adverse supervisory ratings. We are working together in international fora to assure that all internationally active financial institutions are subject to effective regulation. The Federal Reserve is adjusting its approach to prudential supervision, particularly of the largest banking organizations.

Building on the experience of the unprecedented Supervisory Capital Assessment Program, or SCAP, we are expanding our use of horizontal examinations to assess key operations, risks and risk management activities of large institutions. We are creating an enhanced quantitative surveillance mechanism that will draw on a multidisciplinary group of economists and other experts to create and evaluate scenarios across large firms.

These top-down analyses will provide an independent supervisory perspective on the bottom-up work of supervisory teams. The two perspectives will be joined in a well-coordinated process involving both the supervisory teams and Washington staff.

Thank you all for your attention. I look forward to discussing both agency and congressional initiatives to strengthen further our prudential supervisory system.