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Testimony of Daniel Tarullo

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Hearing: Modernizing Bank Supervision and Regulation

March 19, 2009

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

Thank you, Mr. Chairman, Senator Shelby and members of the committee.

We're here this morning because of systemic risk. We've had a systemic crisis. We're still in the middle of it and I would endorse wholeheartedly Senator Shelby's three-part approach to responding to that crisis.

In the weeks that I've been at the Federal Reserve, the discussions that have taken place internally -- both among staff and among the members -- have focused in on the issue of systemic risk and how to prevent it going forward.

The important point that I would make as a prelude to recommendations is that the source of systemic risk in our financial system has to some considerable extent migrated from traditional banking activities to markets over the last 20 or 25 years.

If you think about the problems that led to the Depression, that were apparent even in the 1970s among some banks, the concern would be that there would be a run on a bank. That depositors would be concerned about the safety and soundness of that bank and that there would be contagions spreading to other institutions as depositors were uncertain as to the states of those institutions.

What we've seen more recently is systemic problems starting in the interactions among institutions in markets. Now, banks are participants in markets, so it can still be something that affects banks. But we've also seen other kinds of institutions at the source of the systemic problems that we're undergoing right now. So I think you cannot focus on a single institution or even just look at institutions as a series of silos, as it were, and concentrate solely on trying to assure their safety and soundness. We need to look at the interactions among institutions.

Sometimes that means there're actual counterparty relationships with one another. Sometimes it means the fora in which they interact with one another, the payment systems and the like.

Sometimes it even means the parallel strategies which they may be pursuing, all, for example, requiring -- relying on the same sources of liquidity if they have to change their strategies. So they may not even know that they are co-dependent with other actors in the financial markets.

For all of these reasons, our view is that the focus needs to be on an agenda for financial stability, an agenda for systemic risk management. And I emphasize that because although there is, rightly, talk about a systemic risk regulator, it's important that we understand each component of an agenda, which is going to be fulfilled by all the financial regulators over which you have jurisdiction going forward.

So what does that mean? Well, I tried, in my testimony, to lay out five areas in which we should pay attention.

First, we do need effective consolidated supervision of any systemically important institution. We need consolidated supervision and it needs to be effective.

There are institutions which are systemically important, certainly were systemically important over the last few years, which were not subject to consolidated supervision of a prudential sort by any regulator.

But that supervision needs to be effective. And I think everybody is aware and everybody ought to be aware of the ways in which the regulation and supervision of our financial institutions in recent years has fallen short. And unless, as Senator Shelby suggests, we all concentrate on it and do it without defensiveness, we're not going to learn the lessons that need to be learned.

Secondly, there is need for a resolution mechanism. I'm happy to talk about that in the back-and-forth with you but I think Controller Dugan and Chair Bair -- Chairman Bair have laid that out very well.

Third, there does need to be more oversight of key areas in which market participants interact in important ways. We have focused, in particular, on payment systems, payment and settlement systems because there the Fed's oversight authority derives largely from the coincidence that some of the key actors happen to be member banks. But if they weren't, if they had another corporate form, there's no statutory authority right now to exercise prudential supervision over those markets in which problems can arise.

Fourth, consumer protection. Now, consumer protection is not and should not be limited to its relationship with potential systemic risk. But, as the current crisis demonstrated, there are times in which good consumer protection is not just good consumer protection but it is an important component of the containment of systemic risk.

And fifth and finally, the issue of systemic risk regulator. This is something that does seem to fit into an overall agenda. There are gaps. There are gaps in covering systemically important institutions. There are also gaps in attempting to monitor what is going on across the system. I think in the past there has been times in which there was important information being developed by various regulators and supervisors which, if aggregated, would have suggested developing issues and problems. But without a charge to one or more entities to try to put all that together, one risks looking at things, as I said, in a more siloed fashion.

The extent of those authorities for a systemic risk regulator is something that needs to be debated in this committee and, indeed, in the entire Congress.

But I do think it's an important compliment to the other components of this agenda and the improvements in supervision and regulation under existing authorities and that's something that ought to be considered.

I'm happy to answer any questions that you may have.