Testimony of Robert K. Steel[1]

before the

Joint Economic Committee

Wednesday, December 2, 2009

Chair Maloney; Ranking member Brownback, members of the committee; my name is Robert Steel and I'm pleased to be here today as a member of the bipartisan Financial Reform Task Force.

The Task Force is ideologically diverse and has as its members both academic economists and financial industry practitioners.[2] This group first convened in June with the task of producing bipartisan, consensus recommendations designed to meet one overriding goal: to create a financial system that allows the U.S. economy to grow without the kinds of risk we have recently witnessed and unfortunately experienced. I am pleased to discuss here today, along with my Task Force colleague Robert Litan, our five core principles and the specific recommendations needed to achieve them.[3]

The Task Force developed consensus on most aspects of financial regulation, though some members would have preferred somewhat different approaches with respect to certain individual recommendations. Those who signed the report believe strongly that this entire package would, if adopted, represent a substantial step toward creating the fair, competitive and stable financial system that is a prerequisite for a return to robust economic growth.

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[1] Robert K. Steel is the former CEO of Wachovia, former Under Secretary for Domestic Finance of the United States Treasury and CEO of Grigg Street Capital.

[2] In addition to myself, Task Force signatories include: Martin Baily, Task Force Co-Chair, Senior Fellow, Economic Studies, Brookings Institution; Peter Wallison, Task Force Co-Chair, Senior Fellow at the American Enterprise Institute; Charles Calomiris, Professor of Finance at Columbia University; Morris Goldstein, Senior Fellow at the Peterson Institute for International Economics; Richard Herring, Professor of International Banking at the Wharton Business School; Robert E. Litan, Senior Fellow in Economic Studies, Brookings Institution and Vice President, Research and Policy, Kauffman Foundation; Paul G. Mahoney, Dean of the Law School at University of Virginia; Avinash Persaud, Chairman of Intelligence Capital Limited; Alice Rivlin, Senior Fellow at the Brookings Institution and Visiting Professor at Georgetown University, and; Benn Steil, Senior Fellow and Director of International Economics, Council on Foreign Relations.

[3] The Financial Reform Task Force received supported from The Pew Charitable Trusts. The Task Force recommendations reflect the views of the signatories. The Pew Charitable Trusts takes no position on any of these recommendations.

The Task Force recommendations reflect many of the changes under debate in the House Financial Services Committee and the Senate Banking Committee. Further, they share much in common with the recommendations advanced by Secretary Paulson in June 2007 in the *Blueprint for a Modernized Financial Regulatory Structure*; a report I am proud to have worked on while serving at the Treasury as Under Secretary for Domestic Finance.

The five Principles are:

1. The U.S. must have an early warning system that prevents inappropriate and dangerous financial practices from harming the economy.

2. No financial institution should be too big or complex to fail.

3. A single regulator that's strong and smart should replace the current alphabet soup of agencies.

4. Derivatives markets and market discipline broadly must be strengthened.

5. Consumers need better protection from financial abuses.

I would like to highlight a single, crucial recommendation. What has become known as the Too Big to Fail problem is in many ways at the heart of the financial reform effort. There are different ways to approach this problem. Congress could arbitrarily limit the size of financial institutions; they could limit the scope of their activities; or they could work to ensure that any failure is less likely to cause a financial crisis. We favor the latter. It is a strength of the American system that the opportunity to succeed carries with it the prospect of failure. To my mind, this system provides the best possible opportunity for shared prosperity.

As a result, our Task Force recommends that all financial institutions should be free to fail, but free to fail in manner that will not destabilize the financial system. The Task Force, therefore, recommends three specific things with regard to this issue:

1. A sliding capital scale, so that the larger, more complex, more risky and more systemically important an institution, the higher the standards for capital, liquidity and leverage to which it should be held;
2. Institutions above a certain size should submit for approval a "funeral plan" or "living will" that describes in detail how the firm, were it to fail, could be wound-down, with reduced impact on the overall economy;
3. A new solution should be adopted for failed or failing non-depository financial institutions. While the FDIC should continue to resolve failed or failing banks, we recommend that for non-depository financial institutions there be a strengthened bankruptcy process as the presumptive approach. In exceptional circumstances, only after strong safeguards have been met, there should be an administrative resolution process as an option of last resort.

This proposed two-stage approach to winding down non-bank financial institutions brings together two desirable policy objectives. It maintains the market discipline of the bankruptcy process while, at the same time, providing the government with a new tool to protect the financial system in times of unusual stress. In all cases, moral hazard is reduced, as shareholders, unsecured creditors and senior management will bear the burden of the failure.

To create this two-step process, Congress should first amend the bankruptcy code as necessary to make bankruptcy the presumptive process for managing all failing non-depository financial institutions. In addition, Congress should create a new Federal Financial Institutions Bankruptcy Court (FFIBC) and grant it sole jurisdiction in the United States for these cases.

In those exceptional circumstances when a bankruptcy would pose unacceptable systemic risks, a new administrative process should be created for failing non-depository financial institutions. This process should be used only after strong safeguards have been satisfied.

Congress should decide exactly how strong the safeguards are and what form they should take. For example, Congress could require consultation and formal agreement between Treasury and the concerned federal financial regulatory agencies before the resolution mechanism is activated. Congress could instead opt for a stronger safeguard. This is up to Congress.

There are several methods by which Congress could insert a higher hurdle. Let me outline one that our Task Force considered. If a failing non-depository institution were judged to be a threat to the stability of the financial system, the Administration could seek a Congressional appropriation. While the Administration seeks the appropriation, the firm in question would enter the bankruptcy process in the proposed special-purpose bankruptcy court. Congress would then have a limited and fixed number of days in which to make such an appropriation. A customary stay would apply, and the Fed could provide financing and collateral, permitting the firm to continue to operate while Congress deliberated. If Congress did appropriate, the estate of the firm could be transferred to the administrative procedure. If it did not, the bankruptcy would proceed and the Fed would exercise its collateral once circumstances permitted. As is known, despite being officially "well capitalized" by conventional measures, many large complex financial institutions in the United States were weak going into the crisis: risk management had become ineffective, complexity had become well nigh unmanageable, leverage had become excessive, and liquidity and high quality capital were in short and uncertain supply. When the crisis hit, the federal authorities were ill-equipped to deal with their serial collapse. Confusion over which institutions would be allowed to fail without intervention, and what the consequences of disorderly failure might be simultaneously heightened moral hazard, the scale of the market disruption and the costs to the taxpayer.

While the two stage resolution process is a novel solution I would like to reiterate that many of the other specific Task Force recommendations in support of the Principles mirror many of those under debate in the House Financial Services Committee and the Senate Banking Committee. We commend the hard work already done by the members in both houses of Congress to move this crucial effort forward. The Task Force hopes that our efforts will both complement the current work being done on these issues, as well as to provide additional momentum to the overall financial reform effort. While there are unmistakable signs our economy has stabilized, it is imperative that Congress act with urgency to enact comprehensive and effective reform.

We look forward to your questions about the Task Force and our Principles.

Thank You