Testimony of

Edward L. Yingling

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Committee on Financial Services

United States House of Representatives

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October 21, 2008

Chairman Frank and members of the Committee, my name is Edward L. Yingling. I am President and CEO of the American Bankers Association (ABA). ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.3 trillion in assets and employ over 2.2 million men and women.

Thank you for the opportunity to present the views of ABA on regulatory reform and the restructuring of the financial services marketplace. Clearly, changes are needed. The recent turmoil, stemming largely from abuses brought about by lightly regulated, non-bank institutions, needs to be addressed through better supervision and regulation in certain parts of our financial industry. However, we also need to preserve the best of our current system, while looking for ways to streamline and improve what has been lacking. None of us wants to add layers of regulation that prove to be ineffective and reduce the ability of financial firms to meet the needs of customers. This is why a deliberative and thoughtful process, which you have begun with these hearings, Mr. Chairman, is critical to enacting long-lasting regulatory reform.

Even before the turmoil of the last few weeks, ABA's board of directors recognized this need to address these difficult questions, and our Chairman, Brad Rock, chairman, president, and CEO of Bank of Smithtown, Smithtown, New York, appointed a task force to develop principles and recommendations for change. This task force has only had a chance to meet once, and has not reached any firm conclusions. Thus, we cannot provide a recommended blueprint for a regulatory structure at this time. Nevertheless, we hope we can add value to the discussion.

The banking industry is, of course, already highly regulated. While there is clearly room for improvement in this complex system, it has functioned well for FDIC-insured banks. In fact, in contrast to many other financial institutions, banks have a well-developed system of regulations, constant oversight by examiners, a strong insurance system to protect depositors' money – which is paid for fully by banks – and a process for resolving failed institutions (including provisions for those times when the risks become systemic).

The biggest failures of the current regulatory system have not been in the regulated banking system, but in the unregulated or weakly regulated sectors. As you have noted many times, Mr. Chairman, it has been the largely unregulated, uninsured firms that have created problems.

Indeed, while the system for regulating banks has been strained in recent weeks, it has shown resilience. In spite of the difficulties faced by all businesses – including banks – in this weak economy, I want to assure you that the vast majority of banks continue to be well-capitalized and are opening their doors every day to meet the credit and savings needs of their customers. The actions taken by Congress in the last few weeks – and those by the Treasury, Federal Reserve and the FDIC last week – will certainly help free up capital, which has been nervously waiting on the sidelines.

Thus, there is a strong line of reasoning, which we believe is correct, that the basic system of bank regulation has worked – despite severe strains – while the problems built up outside this regulated system. Nearly a year ago, Mr. Chairman, you summarized the situation very succinctly:

> Reasonable regulation of mortgages by the bank and credit union regulators allowed the market to function in an efficient and constructive way, while mortgages made and sold in the unregulated sector led to the crisis. At every step in the process, from loan origination through the use of exotic unsuitable mortgages to the sale of securities backed by those mortgages, the largely unregulated uninsured firms have created problems, while the regulated and FDIC insured banks and savings institutions have not. To the extent that the system did work, it is because of prudential regulation and oversight.[1]

[1] B. Frank, "Lessons of the Subprime Crisis," Boston Globe (Sept. 14, 2007). The recently-released report of the Majority Staff of the Joint Economic Committee of the United States Senate contains a similar finding, stating -- The mortgages underwritten by subprime lenders come from many sources, but the overwhelming majority is originated through mortgage brokers. For 2006, Inside Mortgage Finance estimates that 63.3 percent of all subprime originations came through brokers …. **Because they are not deposit-taking institutions, the independent mortgage companies and bank subsidiaries are not subject to the safety and soundness regulations that govern federal or**

Given this analysis of the causes of the problem, there has been a logical move to begin applying more bank-like regulation to the less-regulated and un-regulated parts of the financial system. For example, when certain securities firms were granted access to the discount window, they were quickly subjected to bank-like leverage and capital requirements.

As regulatory change points more toward the banking model, so too has the marketplace. The biggest example, of course, is the movement of Goldman Sachs and Morgan Stanley to Federal Reserve holding company regulation. But more generally, across the spectrum of financial services, there is a move back toward the more traditional financial principles of banking: making loans that are designed to be repaid by the customer; maintaining long-term relationships between customers and institutions they can trust; and providing safe places to put savings and investments. It's like the saying: all that's old is new again.

Unfortunately, while both the regulatory model and the business model move toward traditional banking principles, bankers are extremely worried that regulatory and accounting policies could make it impossible for them to serve their communities. Clearly, major changes are coming, and major changes are needed. But time after time bankers have seen regulatory changes aimed at others result in massive new regulations for banks.

There are thousands of banks across the country today that never made one toxic subprime loan. These banks have been serving their communities throughout this crisis. They are well-capitalized, and are making solid loans. These banks have already been hurt deeply by this crisis. It is a classic case of how healthy, well-regulated institutions are badly hurt by unscrupulous players and regulatory failures. First, these banks watched as they lost loan business to mortgage brokers and others who made loans to consumers that a good banker just would not make. Second, these banks watched their local economies suffer when the housing bubble burst. Third, these banks watched the reputation of their industry be tarnished as the word "bank" was used to cover all sorts of financial institutions that were not, in fact, banks. They cringed as they heard Bear Stearns, Lehman Brothers, Fannie Mae, Freddie Mac, and even AIG referred to as "banking failures." Fourth, they now see their deposit insurance premiums increased dramatically as they do their duty to help the FDIC insurance fund stay strong. These bankers do not want or need any government

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state banks. "The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here," Report and Recommendations by the Majority Staff of the Joint Economic Committee, October 2007 (Joint Economic Committee Report), at 17-18 (emphasis in original).

bailout; they want their insurance fund to handle any problems – as it has – including problems with such large institutions as WAMU and Wachovia. Fifth, a number of bankers watched as their preferred shares in Fannie Mae and Freddie Mac were wiped out overnight by government fiat. Sixth, they watched as the freeze-up in international credit markets caused the Congress, and then the Treasury and regulators, to pass and implement a massive rescue package. ***It is a solution that these banks did not seek for a problem they did not cause, and yet all of it is often labeled the "bank bailout."***

Now these thousands of banks of all sizes, in communities across the country, are scared to death that their already-crushing regulatory burdens will be increased dramatically by regulations aimed primarily at their less-regulated or unregulated competitors. Even worse, the new regulations will be lightly applied to non-banks while they will be rigorously applied – down to the last comma – to banks.

This committee has worked hard in recent years to temper the impact of regulation on banks. You have passed bills to remove unnecessary regulation and you have made existing regulation more efficient and less costly. As you contemplate major changes in regulation – and change is needed – ABA would urge you to ask this simple question: how will this change impact those thousands of banks that make the loans needed to get our economy moving again?

There is an additional question that we urge you to ask: is this change pro-cyclical or counter-cyclical? Simply put, too much of our regulation is pro-cyclical: our regulations actually encourage booms and busts. The prime example is accounting policy. Later in the testimony, I talk about the critical need to change the oversight structure of accounting policy, particularly the problems that have arisen from mark-to-market accounting. While I am not going to go into a detailed discussion of that issue in this testimony, I want to make a fundamental point in the strongest terms: current mark-to-market accounting is simply incompatible with the banking system as we have come to know it and as I believe this committee wants it to be. I believe you want banks that are committed to the long-term – providing long-term loans to and investment in businesses, communities, and consumers' futures. To be able to do that, banks must not have their loans and investments marked to prices set in panicked markets. These are long-term investments, not day-to-day trades. Simply put, without changes in accounting policy, the lesson learned from this financial disaster will be that long-term loans and investments will have their valuations destroyed, and therefore the bank will be destroyed, by mark-to-market during financial panics. Banks simply will not be able to make loans and investments with the idea that they will work through hard times with customers and communities.

In the rest of my statement today, I'd like to touch on several key themes that have been the subject of focus for ABA's regulatory reform task force:

- ***Comparable financial activities should be regulated in a similar manner.***
  Regardless of the primary regulator, equal regulation and supervision is critical to preventing excessive risk-taking.
- ***There should be a regulatory structure that provides a mechanism to oversee and address systemic risk.***

  This should include a method to handle the failure of non-bank institutions that threaten systemic risk.
- ***Charter choice should be preserved.***
  This would include preserving all the charters that are insured by the FDIC as well as preserving the state and federal dual banking system. Moreover, an optional federal charter for insurance companies should be adopted.
- ***Oversight of accounting rules needs to be strengthened and rules on short-selling need to be adopted.***

I would like to touch briefly on each of these themes to highlight issues that underlie them. I have also included an appendix that describes the origins of our current system.

Comparable financial activities should be regulated in a similar manner.

Banking is an industry built on confidence. The confidence of customers is protected by a strong regulatory program. The confidence of banks is reinforced by a history of trust between regulator and regulated. Preserving that confidence and maintaining that trust are essential in any kind of regulatory restructuring.

This objective has several facets. First, regulation needs to foster safe and sound operations. Second, it must remove barriers that prevent access to products and services. Third, it needs to promote competition. These facets, while distinct, are wholly compatible. A financial institution will best be able to achieve its business objectives by responsibly managing its risks; by providing a full range of products and services to meet the individual needs of all customers; and by competing against others based on price, product quality, reputation, and service. No bank or its customers benefit from undermining standards of integrity.

None of this speaks to any particular regulatory structure. Rather, policy makers should create a legal framework that supports these goals, allowing for enough flexibility to change with changing times, but insisting upon enough rigor to ensure that bad actors do not slip through the cracks.

Banks have long been subject to the Truth in Lending Act and the Home Owner's Equity Protection Act amendments thereto, the Home Mortgage Disclosure Act, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act, and the Fair Lending Act, among other consumer protection laws. These laws require numerous disclosures relating to mortgage loans generally, and "high-cost" loans in particular, as well as restrictions on fees and other terms for high-cost loans. Additionally, continually updated regulatory guidance is enforced by the banking agencies, including those recently promulgated on nontraditional mortgages[2] and subprime mortgage lending.[3]

Independent mortgage brokers and other originators, by contrast, operate in a much less regulated environment, are not examined, and have different reputational concerns. They have not been subjected to the breadth of consumer protection laws and regulations with which banks must comply. Equally important, a supervisory system does not exist to examine them for compliance even with the comparatively few laws that do apply to them. In addition, independent brokers typically do not have long-term business relationships with their customers. Instead, they originate a loan, sell the loan to a third party, and collect a fee. This results in a very different set of incentives and can work at cross purposes with safe and sound lending practices.[4]

Hindsight reveals what perhaps should have been obvious a long time ago: the combination of little or no regulation, little or no supervision, new products designed to expand mortgage lending, and an incentive structure independent of the market discipline of a long-term customer

[2] 71 Fed. Reg. 58609 (Oct. 4, 2006).
[3] 72 Fed. Reg. 37569 (July 10, 2007).
[4] *See* Joint Economic Committee Report, *supra,* at 20.

relationship is a combustible brew. Clearly the unchecked misuse of legitimate credit products has resulted in a supervisory failure that justifies the additional regulation of mortgage originators that are neither insured depository institutions nor affiliates of an insured institution.

Likewise, it is clear that there are other major gaps in regulation and oversight relating primarily to Wall Street activities. ABA has not yet developed specific recommendations on many of these issues, but we do believe a simple principle should be generally applied: similar activities should have similar regulation. As noted earlier, where similar activities are not similarly regulated, business naturally flows to the unregulated sector, in part because of lower costs. This flow undermines the regulated sector, making it weaker. Too often, the unregulated sector then has a blow-up, which even further weakens the regulated sector.

ABA strongly urges the committee to resist moving the regulatory boxes around just for the sake of change. We had a number of problems with the proposed Treasury blueprint, but one major problem was that it actually made our bank regulatory structure ***more complex***. We would have had a more conflicting regulatory structure. In particular, we urge you not to create a separate consumer regulator for banks. We have enough regulators as it is, and a consumer regulator and a safety and soundness regulator would have inherent conflicts that would pull banks in opposite directions.

Almost every bank "consumer" issue has both consumer issues and safety and soundness issues that need to be balanced and resolved. One simple example is check hold periods. Customers would like the shortest possible holds, but this desire needs to be balanced with complex operational issues in check clearing, particularly with the threat of fraud, which costs banks – and ultimately consumers in the form of increased costs that are passed on – billions of dollars.

There should be a regulatory structure that provides a mechanism to oversee and address systemic risk.

There are obviously gaps in the current regulatory structure. These gaps are of two types. First, although the Federal Reserve may be thought of as generally looking over the economy, it has not really been made clear that one federal agency has the role of overseeing, on a regular basis, the economy to look for potential problems and weaknesses. Nor does one agency have all the information needed to implement such broad oversight. Similarly, no one agency has the authority to lead the implementation of remedial measures when they are needed. Thus, we have had the recent efforts, led by the Treasury and the Fed, which have basically been a series of ad hoc efforts.

The second type of gap relates to holes in the regulatory scheme, gaps where entities escape effective regulation. It is now apparent to everyone that a critical gap occurred with respect to the lack of regulation of independent mortgage brokers. Questions are also being raised with respect to credit derivatives, hedge funds, and others.

As for the first gap, it is clear we need a systemic regulator that looks across the economy and identifies problems. To fulfill that role, the systemic regulator would need broad access to information. It may well make sense to have that same regulator have necessary powers, alone or in conjunction with the Treasury, and a set of tools to address major systemic problems (although based on the precedents set over the past few months, it is clear that those tools are already very broad).

At this point, there seems to be a strong feeling that the Federal Reserve should take on this role in a more robust, explicit fashion. That may well make sense. However, we do want to raise one concern: as the role of the Federal Reserve expands, care must be taken not to undermine the critical role of the Federal Reserve in setting monetary policy. One of the great strengths of our economic infrastructure has been our independent Federal Reserve. We urge Congress to carefully consider the long-term impact of changes in the role of the Federal Reserve and the potential for undermining its effectiveness on monetary policy.

It is for this reason that we do have concerns about proposals to make the Federal Reserve a sort of super-regulator of the financial system. This function would go beyond looking at systemic issues to regulating financial institutions on a daily basis. While ABA has not developed a position, the initial reaction of our task force is that this might not be a proper role for the Federal Reserve.

There is also a clear need for a mechanism to "fail" troubled non-banks when the situation raises systemic issues. There is such a system for banks, and that system can serve as a model. However, the system for banks is based in an elaborate system of bank regulation and the bank safety net. The system for non-banks should not extend the safety net, but rather should provide a mechanism for failure designed to limit contagion of problems in the financial system.

Another hole in the regulatory scheme is the lack of comparable standards for non-banks that participate in the payments system. Banks have long been the primary players in the payments system ensuring safe, secure, and efficient funds transfers for consumers and businesses. Banks are subject to a well defined regulatory structure and are examined to ensure compliance with the standards.

In recent years, non-banks have begun offering "non-traditional" payment services in greater numbers. Internet technological advances combined with the increase in consumer access to the Internet have contributed to growth in these alternative payment options. These activities introduce new risks to the system. Another key difference between banks and non-banks in the payments system is the level of protection granted to consumers in case of a failure to perform. It is important to know the level of capital held by a payment provider where funds are held, and what the effect of a failure would be on customers using the service. This information is not always as apparent as it might be.

The non-banks are not subject to the same standards of performance and financial soundness as banks, nor are they subject to regularly examinations to ensure the integrity of their payments operations. This imbalance in standards becomes a competitive problem when customers do not recognize the difference between banks and non-banks when seeking payment services.

In order to ensure that consumers are protected from financial, reputational, and systemic risk, all banks and non-bank entities providing significant payment services should be subject to similar standards. This is particularly important for the operation of the payments system, where uninterrupted flow of funds is expected and relied upon by customers. Thus, ABA believes that the Federal Reserve should develop standards for integrity of the payments system that would apply to all payments services providers, comparable to the standards that today apply to payments services provided by banks. The Federal Reserve should review its own authority to supervise non-bank service providers in the payments system and should request from Congress those legislative changes that may be needed to clarify the authority of the Federal Reserve to apply comparable standards for all payments system providers.

Charter choice should be preserved.

Having choices of charters enables a bank to match the best charter to its philosophy and business strategy. This also allows regulation and supervision to be targeted to meet the particular risks that may arise. This helps preserve the diversity of financial institutions without sacrificing safety and soundness.

Once the initial determination about which charter to select is made, charter choice remains a useful check to ensure the primary regulator does not become too calcified for an ever-changing financial marketplace, grow overly bureaucratic and ineffective, or otherwise impose regulatory conditions inconsistent with the ability of financial firms to serve their customers. All of these ills have happened and do happen, but our current regulatory system of charter choice and regulatory diversity – particularly in the case of banking regulators – works to prevent these ills from persisting. Charter choice has also encouraged innovation among regulators, where improvements by one regulator can be adapted by others. The best programs are the ones that best facilitate the ability of firms to serve their customers.

Charter choice also remains an important consideration as financial institutions' business models evolve. For instance, while a community bank may conclude that a state charter is best when the bank first begins operations, it may conclude later that its expansion plans would best be facilitated by a national bank or federal thrift charter. Or it may conclude that some services are best met with a mix of charters, perhaps concentrating mortgage business in one, commercial lending in another, credit card activities in yet another, and trust activities in still another. The combinations are as diverse as the purposes and markets and customers to be served.

Regulatory agencies, recognizing the need for the financial institutions within their jurisdiction to evolve in order to remain competitive, have applied the laws within their purview in ways that continually strive to balance safety and soundness with innovation, both of which are high priorities for financial customers. The result is more products – and more convenient access to products – at lower costs, to more customers in more parts of the world than ever before. A prime example of this dynamic at work is when the NOW account was created by state chartered institutions in New England, leading fairly quickly to customers being able to earn interest on checking accounts throughout the country.

It is also noteworthy that there have been few problems caused by our country's dynamic dual banking system and charter choice. While there are regulatory squabbles from time to time, the system has worked well, particularly from a safety and soundness point of view. The importance of dynamism and innovation in product development and in regulatory application should not be underestimated, nor should it be sacrificed to theories about efficiency or regulatory structure. It is for that reason that ABA continues to support maintaining the Office of Thrift Supervision.

We also want to emphasize the importance of the mutual structure. Mutuals have stood the test of time and continue to serve their communities in exemplary fashion. While we have not seen any explicit proposals that would weaken mutual institutions, nor is there any reason why there should be, as Congress looks at restructuring regulatory agencies or charters, it is critical that mutual institutions not be negatively impacted.

In fact, the benefits of bank charter choice and agency plurality should be applied to the insurance industry. An optional federal charter and the attendant safety and soundness standards could address problems that have surfaced in the insurance industry as well. Any proposal for an optional federal charter likely would be coupled with rigorous rules governing financial solvency and permissible investments, and insurance companies would be examined to ensure compliance with these rules. In this way, customers would have confidence that a federally-chartered insurer would be able to pay claims on its policies. In fact, given the current problems in the financial markets, it would be a remarkable oversight for Congress not to develop a federal approach to insurance regulation.

Insurance customers also would benefit from nationwide, uniform policies and sales practices. An optional federal charter would make it possible to offer the same life insurance policy in every state. Companies could use the same policy form, same disclosure statements, and same administrative procedures throughout the country. And, because their conduct would be governed by uniform rules, insurance companies no longer would be impeded by the many variations in state laws from using the Internet to offer insurance products.

Moreover, the current insurance regulatory system greatly impedes our ability to negotiate in the international regulatory arena. Domestic institutions are represented by a variety of state insurance regulators who, by definition, do not and cannot speak for the United States as a whole. Moreover, the difficulty of entering the U.S. markets under the current state regulatory system dissuades foreign capital from investing in the U.S., thereby restricting overall insurance capacity and reducing the number of insurance products available to U.S. consumers. It simply is the case that relatively few foreign companies are willing to expend the time and resources necessary to navigate all of the harbors in our state-based regulatory system.

Oversight of accounting rules needs to be strengthened and rules on short-selling need to be adopted.

Two actions have significantly accelerated the financial crisis and the credit crunch: the downward spiral of the book values of assets on bank balance sheets caused by mark-to-market accounting rules and the precipitous drop in stock prices caused in part by the illegal naked short-selling of bank stocks. No one would suggest that these actions caused the problem, but they have made it much worse than it needed to be. While the Securities and Exchange Commission (SEC) in recent weeks has taken some steps to ameliorate these situations, Congress should address these two issues, not only to help mitigate the current financial disruptions but also to prevent a repeat of the turmoil experienced in the last year.

Accounting standards are not only measurements designed to ensure accurate reporting, but they also have an increasingly profound impact on the financial system – so profound that they must now be part of any systemic risk calculation. No systemic risk regulator can do its job if it cannot have some input into accounting standards – standards that have the potential to undermine any action taken by a systemic regulator.

Today, as a practical matter, accounting standards are made with little accountability to anyone outside the Financial Accounting Standards Board (FASB). That was by design: if there is accountability, there can be influence. Accounting policy was designed to be made by accounting experts, without the perils of outside influence. The SEC has long been authorized to prescribe accounting rules for public companies, but, as the law expressly permits, it has delegated rule-making to a standard-setting body. Recently the SEC did ask the FASB to "expeditiously address issues" related to the accounting rules for other than temporary impairment (OTTI). It also provided guidance on assessing declines in fair value for perpetual preferred securities under the existing OTTI model. While we greatly appreciated the SEC's action – which ABA had strongly urged – the fact that it was considered in the accounting world to be an extraordinary "intervention" shows how hands-off the SEC has historically been.

Given the critical role of accounting in economic growth and stability, there are three issues that Congress should consider.

1. **The structure and process of FASB, including the process by which it makes decisions**. Although ABA has always appreciated the openness with which FASB has listened to our concerns and recommendations – as well as those of other interested parties – FASB does not follow any formal procedures to ensure transparency (such as the Administrative Procedures Act) nor does it ensure that the benefits outweigh the costs.

2. **The degree of oversight of the federal government**. The SEC has been content to leave the structure of that oversight vague and, in fact, has seldom intervened – at least publicly – on critical issues.

3. **Where oversight should be housed**. As a practical matter, the oversight structure will very much determine the outcome of the first two issues. The SEC, understandably, was given this oversight role originally because it regulated public company disclosures, and accurate financial reporting was central to the functioning of our capital markets. Now that it has become apparent that accounting rules can have deep economic and systemic effects, Congress should consider whether that authority properly rests within the SEC.

In creating a new oversight structure for accounting, independence from outside influence should be an important component, as should the critical role in the capital markets of ensuring that accounting standards result in financial reporting that is credible and transparent. But accounting policy can no longer be divorced from its impact; the results on the economy and on the financial system must be considered.

ABA today calls on Congress to establish an accounting oversight board, chaired by the chairman of the systemic oversight regulator. Indeed, it would seem that a systemic oversight regulator could not possibly do its job if it cannot have oversight over accounting policies, policies which increasingly and profoundly influence the degree and pace of economic dislocations and the basic structure of our financial system. The SEC Chairman could also sit on this board. Other regulators and Treasury might be members as well, although the smaller the better. This board could still delegate the basic standard-setting to an independent private-sector body, but the oversight process would be more formal, transparent, and robust. Since there is a movement toward convergence of accounting rules internationally, this oversight board would be charged with overseeing international coordination, as well.

Let me now turn to the issue of short-selling. In the last year, there has been a marked increase in short interest in bank stocks and, in July, that interest took a decidedly sharp turn upwards. Banks of all sizes saw precipitous drops in stock prices, extremely high trading volumes, and huge spikes in failures to deliver or FTDs. It is generally recognized that FTDs are indicative of naked short selling, as they represent, in effect, an excess of promises to deliver stock compared with the supply of actual stock when delivery is due, a condition likely caused in large measure by naked short sales. Repeatedly this summer, the ABA called on the SEC to expand its July 15, 2008 order banning naked short selling in 19 financial stocks to include all publicly traded banks and bank holding companies.

Not surprisingly, the ABA voiced strong support for the SEC's September 17, 2008 decision to ban naked short selling in all public companies. Two days later, on September 19, the SEC took the unprecedented step of temporarily halting short selling in a large number of bank and other financial stocks. The SEC took this latter step acting in concert with the U.K. Financial Services Authority (FSA), which a day earlier had similarly banned short selling in U.K. financial sector companies. The ABA strongly supported the SEC's actions, specifically recognizing that a ban on legitimate short selling was an extraordinary measure but that extraordinary times call for such actions.

The September 19 ban on short selling in financial stocks expired almost two weeks ago, three business days after the President signed into law the Emergency Economic Stabilization Act. Since that time, the markets have become increasingly volatile and bank stock prices have not been immune.

We believe that more can and should be done. First, the temporary halt in short selling of financial stocks should be reinstated until such time as the TARP Capital Purchase and Auction Purchase programs are operational. We note that the FSA's ban on short selling does not expire until January 16, 2009, and a similar lengthy ban on short selling of U.S. financials would hopefully pave the way for a return to more calm and rational markets in bank and other financial stocks.

Second, the initial halt in short selling of financial stocks applied to just over 799 financial companies and was later expanded to include reportedly 1000+ financial firms. Most, if not all, of the impacted firms were exchange-listed companies. Because many of our members are publicly traded banks and bank holding companies that are traded over-the-counter, not on an exchange, we would strongly urge that consideration be given to including these firms in the ban.

Third, the uptick rule should be reinstated in some format. Adopted in 1938, that rule generally required that every short sale be entered at a price that is higher than the price of the previous trade. After extensive study and pilot testing, the SEC eliminated the uptick rule in the summer of 2007, just at the beginning of the current market turmoil. Many of our members have been telling us that it is essential that the SEC reinstate the uptick rule in some fashion and authorities, such as Duncan Niederauer, CEO of NYSE Euronext, agree.

We understand that the NYSE Euronext is also considering adopting individual stock circuit breakers that would halt trading when an individual stock drops to some predetermined level. While this could be helpful to those of our members that are traded on an exchange, it would not offer any relief to those community banks that are traded over-the-counter.

Finally, we would suggest that when the markets become more rational and short selling returns to performing, among other things, the legitimate price discovery role that it has historically occupied, that short sellers be required to disclose periodically to the market their short interest activity. Concerned about "a substantial threat of sudden and excessive fluctuations of securities prices" and disruption in the fair and orderly functioning of the securities markets, the SEC has recently adopted an interim rule that requires institutional managers to report weekly certain short sale information to the SEC. Information gathered under this rule is not available to the public. While we continue to study the interim rule, we note that it may make sense for the SEC to consider whether there is some manner in which this information could be made available to the public on a delayed basis. Such a step could bring much needed transparency to this area of the markets. As one of our member bankers told me, "I know who is long in my stock, why can't I know who is short in it as well."

Conclusion

Clearly, it is time to make changes in the financial regulatory structure. We look forward to working with Congress to address needed changes in a timely fashion, while maintaining the critical role of our nation's banks.

Appendix A:

Origins of the Current System

A brief overview of the origins of financial institution regulators and the evolution of their authority helps place the current system in context and illustrates the unique features of each regulator. It also demonstrates how our current system, which some would criticize as haphazard, has in fact been shaped and developed by real-world experience, growing and evolving along with our economy.

Office of the Comptroller of the Currency (OCC). The OCC was created in 1863 in part to address the problems created by each bank issuing its own currency and in part to finance the Civil War. By 1860, there were over 1500 state banks, circulating a total of over 9,000 different types of bank notes. This made commerce very difficult. Notes issued by a bank in one market either would not be accepted by banks elsewhere or would be accepted at widely varying rates, counterfeiting was a serious problem, and a bank's notes frequently remained in circulation after that bank had defaulted.

To address these concerns, Congress created the OCC in 1863[5] and later imposed a 10 percent tax on state bank notes.[6] This effectively ended the issuance of such notes, and many state banks converted to a national charter thereafter. The creation of the national charter also helped defray the costs of the war by requiring all national banks, before opening for business, to buy government bonds to secure bank-issued notes. National banks also were required to tender to the United States Treasurer government bonds in an amount equal to one-third of the bank's capital.

Treasury Secretary Chase's goal of eliminating the state banking system was almost realized, as the number of banks with state charters declined to 247 by 1868. Fortunately for bank customers and the nation as a whole, state banks were allowed by their charters to innovate, resulting, for example, in the development of consumer deposit and checking accounts. State banks again thrived, with over 10,000 banks operating under state charters by 1906, competing alongside more than 10,000 national banks.[7] Unwittingly, Secretary Chase succeeded in launching our dual banking system, a key driver in the development and vitality of the American banking industry for over a century.

Board of Governors of the Federal Reserve System. The nation experienced a series of sharp economic declines in the late 19th and early 20th centuries, culminating in the financial panic of 1907. The stock market had fallen over 50% from its high the previous year, there were several runs on banks, and the money supply was tight. The Treasury Department and several bankers (most notably J. P. Morgan) took several steps to inject additional liquidity, and the economy quickly recovered. The nation's vulnerability to an unpredictable money supply was underscored by these

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[5] 12 Stat. 665 (1863).
[6] 13 Stat. 484 (1865).
[7] States vested state-chartered banks with several powers that were unavailable to national banks at the time, including the authority (a) to obtain funds from deposits instead of through the issuance of bank notes, (b) to establish branches, and (c) to engage in trust activities. As a result, the state bank charter prospered, as evidenced by the fact that by 1892 state banks outnumbered national banks and have done so ever since.

events, however. To address this problem, Congress established the National Monetary Commission in 1908, which issued a report that ultimately led to the creation of the Federal Reserve System in 1913. That system was created "…to furnish an elastic currency, to afford means of rediscount and commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."[8]

Federal Deposit Insurance Corporation (FDIC). In response to an unprecedented number of bank failures during the Great Depression (over 4,000 banks closed in 1933 alone), Congress created the FDIC to supervise a new program of federal insurance for bank deposits. Specifically, the FDIC was established to protect bank depositors, maintain confidence in the banking system, and promote safe and sound banking practices.[9] All national banks and all members of the Federal Reserve System were required to be insured, while state non-member banks could obtain deposit insurance by applying to the FDIC.

Federal Home Loan Bank Board (FHLBB). Savings associations were experiencing problems in the 1930s as well, but the problems they faced were unlike the problems experienced by banks. These institutions were all in the mutual form of organization and were unable to raise capital to support the home mortgage lending that was their single line of business except through the gathering of deposits or membership shares.[10] During their earliest history, mutual institutions raised funds that they then used to make mortgage loans by selling shares in the institution to the borrowers of mortgage credit. These shares had a long duration, often exceeding 12 years, and shares were liquidated when the mortgage needs of all shareholders were satisfied.

In the 1930s, savings associations had a mortgage foreclosure rate of approximately 14 percent (as compared to approximately 6 percent for commercial banks). Because savings associations' portfolios consisted primarily of mortgage loans, investors became wary of buying shares in the associations, and the number of thrifts shrank by 25 percent from 1930 to 1933. In 1932, as a result of the number of foreclosures, the Federal Home Loan Bank System was created as a source of liquidity for its members. The twelve Federal Home Loan Banks provided low-cost advances to the mortgage lenders.

The Home Owners Loan Act was enacted in 1933 to address continuing foreclosure problems. It authorized the Home Owners' Loan Corporation to acquire and refinance mortgage loans, and it authorized the FHLBB to charter federal savings associations. Additional responsibilities and powers were granted to the twelve Federal Home Loan Banks, which became part of the FHLBB regulatory structure. The Federal Home Loan Bank System functioned as the central bank and primary federal regulator for federal savings associations. The Federal Savings and Loan Insurance Corporation (FSLIC) was created a year later to insure savings accounts, thereby making it easier for savings associations to attract funds that could be used for additional home mortgage credit. The FSLIC was also granted regulatory authority over state savings associations. As originally created, the FSLIC was a separate entity under the direction of the FHLBB. Thus, the FHLBB had authority for chartering, supervising, and insuring federal savings associations, and the Federal Home Loan Bank System had additional authority over state associations. The Federal Home Loan Bank System's secondary

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[8] 38 Stat. 251 (1913).
[9] 48 Stat. 162 (1933).
[10] Savings associations were prohibited from offering transaction accounts until 1968. See Pub. L. 90-448, §1716(a).

market role was deepened when the Federal Home Loan Mortgage Corporation (Freddie Mac) was created in 1970 and placed under FHLBB supervision.

The FHLBB's responsibilities for prudential regulation, insurance, and oversight of the secondary market continued until 1989. Congress, responding to the problems that developed in the thrift industry in the 1980s, enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which abolished the FHLBB and decentralized its functions, dividing its responsibilities among four agencies. Insurance of accounts was transferred to the FDIC (which was given authority to administer the newly-created Bank Insurance Fund and Savings Association Insurance Fund). Prudential supervision of state and federal savings associations was transferred to the newly-created Office of Thrift Supervision (OTS). The regulatory authority of the Federal Home Loan Banks over savings associations was transferred to the OTS, oversight of the Federal Home Loan Banks advance business and other operations was transferred to the newly-created Federal Housing Finance Board, jurisdiction over Freddie Mac was given to the Office of Federal Housing Enterprise Oversight.

Regulation of bank and thrift holding companies. The next major piece of banking legislation that affected the structure and supervision of financial institutions came in 1956 with the enactment of the Bank Holding Company Act (BHC Act). This legislation was conceived in response primarily to two developments: the increased involvement of banks in non-traditional bank activities and the ownership of multiple banks by a single corporation to accommodate business growth within the context of interstate branching restrictions. The Federal Reserve System was given jurisdiction over multi-bank holding companies – bank holding companies (BHCs) that own more than one bank – in 1956 and jurisdiction over single BHCs in 1970.

Congress enacted legislation in 1967 affecting the activities of savings and loan holding companies (SLHCs). The comprehensive Savings and Loan Holding Company Act differed from the legislation governing BHCs in that "unitary" SLHCs – *i.e.*, SLHCs that owned only one savings and loan association – were permitted to mix banking and non-financial commerce. In 1987, Congress determined that savings association subsidiaries of SLHCs must meet the "qualified thrift lender" (QTL) test.[11] FSLIC (under control of the FHLBB) was given jurisdiction over SLHCs, although jurisdiction for SLHCs was transferred to the OTS upon its creation in 1989.

Securities and Exchange Commission (SEC). Confidence was lacking not only in banks but also in the stock markets in the early 1930s. In September of 1929, the Dow Jones Industrial Average reached what was then an all-time high of 381. However, due to a combination of factors, prices declined until July of 1932, when the Dow bottomed out at 41. Congress created the SEC in 1934 in an attempt to restore investor confidence in the capital markets by preventing abuses arising in connection with the sale of securities. The SEC was given exclusive jurisdiction over the securities markets and securities activities not conducted by banks. Over time, much of the SEC's regulatory

[11] Originally, the QTL test required that 70 percent of the assets of a savings association must be housing-related loans. The current QTL test requires that at least 65 percent of an institution's assets must be "qualified thrift investments." These investments include, for instance, home loans, educational loans, small business loans, and credit card loans. *See* OTS Regulatory Bulletin 32-24 (2002).

activity has been conducted via a network of SEC-supervised self-regulatory organizations (SROs), such as the Financial Institutions Regulatory Authority (FINRA) and the stock exchanges.[12]

Gramm-Leach-Bliley modernization. The landscape governing the charter choices available to, and the regulation of, financial institutions was changed significantly with the enactment of the Gramm-Leach-Bliley Act (GLBA) in 1999. GLBA was enacted to remove legislative impediments to the full realization of financial institutions' potential. In a sense, the law was playing catch-up to the innovations that were taking place rapidly in the years leading up to its passage. It did so by embracing regulatory diversity, clearing the way for financial holding companies to accommodate a wide variety of business models with the mix of financial charters most appropriate to meet the needs of their customers.

GLBA brought about the following changes, among others:

- Bank holding companies were permitted to engage in activities that are (a) financial in nature or incidental to financial activities or (b) complementary to a financial activity, provided the complementary activity does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.[13]
- A new entity – called a "financial holding company" (FHC)[14] – was recognized and authorized to engage in the nine activities enumerated in GLBA as "financial in nature" (including securities underwriting and dealing and insurance underwriting and sales) and any other activity that is financial in nature or incidental or complementary thereto. The Federal Reserve Board was designated as the "umbrella supervisor" of FHCs.
- The newly permitted activities were made subject to "functional regulation," whereby the securities activities of non-depository subsidiaries of holding companies are regulated by the SEC and the insurance activities of such subsidiaries are regulated by state insurance departments. Securities activities conducted directly by a bank are regulated by either the bank's primary regulator or the SEC (depending on the activity),[15] while insurance activities conducted directly by a bank are regulated by the bank's primary regulator.
- The SEC was given jurisdiction over "investment bank holding companies" (which are diversified nonbank investment banking organizations). The SEC later assumed supervision of the larger investment banking firms under the voluntary "consolidated supervised entities" program. Consolidated supervised entities are broker-dealer holding companies that own bank and nonbank subsidiaries. On September 26, 2008, the SEC announced that it was disbanding the CSE program.
- The ability of newly-formed unitary savings and loan holding companies to have commercial parents or affiliates was repealed. The activities and authorities of unitary savings and loan holding companies existing in 1999 were grandfathered. Any savings and loan holding companies created after 1999, with some exceptions, have the authorities of financial holding companies.

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[12] FINRA is the successor organization to the National Association of Securities Dealers (NASD) and the former enforcement arm of the New York Stock Exchange (NYSE Regulation, Inc.). NASD and NYSE Regulation, Inc. merged on July 26, 2007.

[13] GLBA identified several activities as "financial in nature," including lending, providing insurance, and engaging in underwriting or dealing in securities. GLBA § 103(a), codified at 12 U.S.C. 1843(k).

[14] An FHC is a bank holding company, a securities firm, or an insurance company that acquires a bank.

[15] Bank transfer agency activity is regulated by the SEC under Section 17A of the Securities Exchange Act of 1934, 15 U.S.C. 78qA.

These changes reflected the steady evolution in the business leading up to the enactment of GLBA. Financial innovation and competition led banks, securities firms, and insurance companies to offer products that increasingly shared common characteristics. As a result, the distinctions between deposit products, securities, and insurance have become difficult to discern at times. A good – but by no means the only – example of how competing products were developed under differing charters is provided by the bank investment contract: this product can be regulated as an insurance product, a security, or a deposit.

Recognizing the similarities of many of the products offered by the wide range of financial institutions, Congress established a procedure in GLBA for determining what is a banking product and what should be treated as a security or as insurance. Several products were identified as "banking products" or "financial in nature" in GLBA. The Federal Reserve Board and the Treasury Department were given authority to determine what else is "financial in nature," while the SEC was directed to conduct a rulemaking before concluding that any "new hybrid product"[16] is a security.

Thus, today we have a system of multiple regulators supervising and regulating different components of the financial services industry. The system is undeniably complex, and no one set out to design what we have. But it works. It works because it evolved through experience in our financial markets. As it has evolved, our system progressively has provided more room for innovation and competition. While there are opportunities for improvement, our basic structure of regulation and supervision has fostered the most effective, creative, and resilient financial system in the world. It is a financial system that neither relies upon a single firm nor a single regulator to succeed or to progress.

Our financial system also is dynamic, with a dynamism that inheres in the regulatory program while finding even more expression among the firms in the financial industry. That dynamism continues to provide new and better products to serve ever more financial services customers. The regulatory system operates under a tempered dynamism, however, with key policy changes usually relying upon the cooperation of other regulatory players. The result is not nimble, but it is an effective check against risky regulatory experimentation. In effect, our system provides ample room for experimentation in the marketplace while moderating experimentation among regulators.

[16] A "new hybrid product" is defined as any product that was not regulated by the SEC as a security before GLBA, is not an "identified banking product" as GLBA defines that term, and is not an equity swap that is sold directly to a non-qualified investor.