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FINANCIAL REGULATION: A POST-CRISIS PERSPECTIVE FEATURING MARTIN J. GRUENBERG, CHAIRMAN OF THE FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

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P R O C E E D I N G S

MR. KLEIN: Good afternoon. I'm Aaron Klein, fellow in Economic Studies and director on the Center on Markets and Regulation. It's my privilege to welcome you all here today.

And it's my distinct honor to introduce Chairman Martin Gruenberg. Marty's the 20th chairman of the FDIC. He received Senate confirmation five years ago tomorrow for his five-year term. Prior to that he served as vice chairman and a member of the FDIC board of directors, going all the way back until 2005. My how the financial system felt quite different back then. He had two stints as acting-chairman before now serving his full term as chairman.

For those of you who have been in this town and worked in financial regulation and on banking and housing issues, you've known and come across Marty's path for decades. It's hard to imagine any of the names of the laws that we call Fiducia Firea, Grimm-Leach-Bliley, Sarbanes-Oxley and Dodd-Frank as having existed without Marty's work and input and helping and shaping and crafting those.

I won't go through all the various roles he's served. I do want to highlight one. In addition to Marty's work domestically, he served as chairman and president of the International Association of Deposit Insurers from November, 2007 until November, 2012, helping to bring this concept of deposit insurance and the evolution of that through the financial crisis on a global level. It's with that information that I hope you understand that Marty, who's a proud alumnus of Princeton, truly has fulfilled the motto of the university, which is "Princeton in the nation's service and in the service of all nations." So with that I'd like to welcome to the stage Chairman Martin Gruenberg.

MR. GRUENBERG: Good afternoon everybody. And, Aaron, thank you for that overly generous introduction. It probably pays that Aaron and I at one point worked together on the staff of the Senate Banking Committee.

Let me begin by thanking the Brookings Center on Regulation and Markets, and

my friend, Aaron Klein, for the invitation to speak here today.

You know, I joined the board, as Aaron indicated, in August of 2005, which is over 12 years ago. I am now, I'm told, the longest serving inside director in the FDIC's history. And was confirmed as chairman, as Aaron indicated, in November of 2012. As a result, I've had the opportunity and the privilege to serve at the FDIC prior to the recent financial crisis, during the crisis, as well as during this post-crisis period. I thus have some perspective to offer on this truly extraordinary period of U.S. financial history. And that's my purpose here this afternoon.

Much has changed in banking and bank regulation since I started at the FDIC 12 years ago. Yet I confess to having a certain sense of Deja vu. Banking conditions today are strong, and the possibility of a serious downturn any time soon is generally viewed as remote. That was certainly true during the pre-crisis years as well.

So if I have one key point to make today, it is that we should guard against the temptation to become complacent about the risks facing the financial system. That, to me, is the key lesson that we should learn from the crisis. And I basically want to expand on that thought this afternoon.

In my remarks I will outline the experience of the crisis and the post-crisis reforms. And then draw on that experience in regard to our situation today and going forward.

So let me start at the beginning. When I joined the FDIC board in 2005, banks were benefitting from a decade of benign economic conditions, interrupted only by relatively mild recession in the early 2000s. The FDIC was in the midst of a two and a half year period without a bank failure. That's the longest such period in the history of the agency.
The number of problem banks was approaching historic lows, strong loan growth helped insured banks set six consecutive annual earnings records, from 2001 to 2006.

Banking conditions seemed so favorable that friends asked me at the time if I really wanted to become a member of the FDIC board. After all, nothing was happening in the banking industry so I might be bored over at the FDIC. That's true.

In retrospect, it's now clear that we, both the public and the private sectors, greatly underestimated the risks that we were facing. The economic boom that occurred during the first half of the decade of the 2000s masked a significant buildup of risk in the banking industry. The banking agencies did not appreciate the full extent of these risks, and the bank regulatory framework did not provide adequate safeguards for financial stability. The activities of financial institutions operating under the pre-crisis rules fueled the housing bubble and contributed to the collapse of the financial system.

Examples include the excessive use of financial leverage and inadequate liquidity at a number of large financial institutions, the securitization of large volumes of poorly underwritten mortgages, and the growth of a large and opaque network of credit derivatives backing those securitizations. The confluence of these factors led to the need for taxpayer bailouts on an unprecedented scale.

Our country paid a high price for not recognizing the magnitude of the risks we were facing in the pre-crisis years and for the weaknesses in the bank regulatory framework. The effects of the financial crisis and accompanying recession on the U.S. economy were profound, and nearly catastrophic. Nearly nine million people lost their jobs, more than 12 million homeowners faced foreclosure, and millions of other households remained under water on their mortgages for many years.

Most estimates put the loss of U.S. GDP from the crisis at between 10 and 15 trillion dollars. Without massive assistance from the Federal Reserve, the Treasury and the FDIC, things could have been much worse.

Now in the aftermath of the crisis the banking agencies implemented a number of prudential reforms to address weaknesses in the regulatory framework. Many, but not all of the reforms, were directly primarily at large institutions. The core reforms addressed risk-based and leveraged capital, liquidity, proprietary trading, margin for non-clear swaps, and tools to enable the orderly resolution of systemically important financial institutions in order to prevent taxpayer

bailouts.

If I may I'd like to touch briefly on each of these reforms just as a background to this discussion. As you know, capital absorbs losses and reassures counterparties about a bank's viability. It supports the bank's ability to lend and grow prudently, and helps address moral hazard problems by insuring banks have meaningful equity stakes at risk.

The banking agencies strengthen the quality of regulatory capital and the level of risk-based capital requirements. The agencies also required larger internationally active banks to meet an enhanced supplementary leverage capital requirement that accounts for certain off-balance sheet assets.

The strength and risk-based and enhanced leverage requirements complement each other. Risk-based capital is sensitive but it's also complex and premised on the idea that the risk-facing banks can be reliably measured. Leverage capital is not risk sensitive, but it is simple and provides assured loss absorbing capability.

Now the crisis was also a reminder of the danger to banks of operating with insufficient holdings of liquid assets and of excessive reliance on short term and potentially volatile funds to finance lending and investment activities. There were no regulatory liquidity requirements in effect for large banking organizations before the crisis. The agencies addressed this by finalizing the liquidity coverage ratio, or LCR, to require sufficient liquid asset holdings to meet a short-term period of liquidity stress. The agencies have also proposed the Net Stable Funding Ratio rule, or NSFR, to constrain the extent of longer-term funding and balances between assets and liabilities.

The Volcker Rule addresses certain types of speculative trading and investment activities and reduces the likelihood that Federal Deposit Insurance will subsidize them. As an example, some Collateralized Debt Obligations, or CDOs, that were an accelerant to the crisis, such as CDOs backed by derivatives or other securitizations, would have met the Volcker Rule's current definition of covered fund. Had it been in place then, the Volcker Rule would

have constrained the proliferation of such instruments.

And the Margin Rule is another core and critical reform. The buildup of large uncollateralized swaps positions between and among large financial institutions before the crisis made the financial system more fragile and interconnected and contributed to the rapid unraveling of the system that occurred in 2008. The Margin Rule, which requires the prudent posting of collateral to back stop non-clear swaps positions reduces the systemic risks associated with large derivative exposures.

Now finally, another key post-crisis reform is the development of a framework to address the potential failure of the systemically important financial institution. Since this is a matter of particular responsibility for the FDIC I want to spend a minute talking about.

Broadly speaking, prior to the recent financial crisis, we in the United States, and fair to say other major jurisdictions around the world, had not envisioned that globally active systemically important financial institutions could fail. These institutions, although large and complex, were considered well diversified with operations spanning global markets and different business lines. Putting them, it was thought, at a low risk of failure. It was assumed that these institutions had ready sources of liquidity, and should problems arise, that they would be able to raise large amounts of equity or debt.

Looking back, it is clear that we were unprepared for the challenges we faced. Lacking the necessary authorities to manage the orderly failure of the SIFI, U.S. policymakers were forced chose between two bad options, taxpayer bailouts or financial collapse.

Since the crisis, addressing this challenge has become a top priority in jurisdictions around the world. It became clear that the financial regulatory structure needed to be strengthened for resolution with defined authorities, designated agencies, and demonstrable operational capabilities and resources.

The Dodd-Frank Act included provisions that addressed these critical gaps in authority in the United States, and established a framework designed to ensure that

policymakers and taxpayers would not be put in the same position as in the fall of 2008.

Bankruptcy is a statutory first option under that framework. In order to improve SIFI, significantly important financial institution, in order to improve SIFI resolution and bankruptcy the Act requires that the largest bank holding companies and designed non-bank financial companies prepare resolution plans, often referred to as Living Wills. These plans must demonstrate that the firm could be resolved under bankruptcy without severe adverse consequences for the financial system of the U.S economy.

Living Wills have proven enormously helpful to firms and regulators, and they have facilitated significant structural and operational improvements within firms to improve their resolvability.

As an additional and important safeguard, the Dodd-Frank Act created the Orderly Liquidation Authority for circumstances when an orderly failure and bankruptcy might not be possible. This authority allows the FDIC to manage the orderly failure of the firm, when failure and bankruptcy might threaten financial stability. Coupled with the Federal Reserve's Total Loss Absorbing Capacity Rule, or TLAC is the acronym, which requires a minimum amount of long-term unsecured debt that can be converted to equity and resolution.

These authorities work together to increase the likelihood that financial markets in the broader economy, can weather the failure of a systemically important financial institution that shareholders, creditors and culpable management of that institution will be held accountable without cost to taxpayers, and that such an institution can be wound down and liquidated in an orderly way.

The fact that the credit rating agencies have lowered the credit ratings of the eight U.S. globally systemic banking organizations, that's G-SIBS for short, because of a reduced expectation of taxpayer support in the event of failure, is a sign of progress in this area.

Improved resolution mechanisms to the largest financial institutions have not been limited to the United States. Other leading jurisdictions around the world also have

enacted expanded authorities for the resolution of their large complex financial institutions. And we have worked together to foster the cross-border coordination crucial to effective implementation of these tools.

Until we actually execute a resolution using these authorities, from my standpoint, we should be cautious about making bold statements. However, we have a domestic and international framework in place today that did not exist in 2008, that would have been extremely helpful in 2008, and that should promote a better outcome in the future.

These core reforms that I've outlined have been strongly in the public interest. Large banking organizations now operate with roughly twice the capital and more than twice the liquidity relative to their size than they did entering the crisis. Simply put, they can now absorb more losses and are less likely to fail. Beyond that, having more capital helps banks mitigate the contraction in lending that typically occurs during an economic downturn.

I would also emphasize that these core reforms have promoted a strong banking industry that can support economic activity. By any traditional measure, the performance of the U.S. banking industry and its support to economic growth in the United States has been strong in this post-crisis period. And let me touch on a few of those measures to support that point.

Earnings growth for insured banks as a group has been strong, with annual increases in net income, averaging 7.8 percent per year during the five years ending in 2016. FDIC insured institutions reported a record $171.3 billion in net income in 2016. That's a 44 percent increase from the 2011 level. Through the second quarter of 2017, the earnings picture for insured banks continued to improve. Second quarter net income for insured banks as a group was up 10.7 percent from a year earlier, while the average return on assets of 1.14 percent was the highest in 10 years.

It's worth noting that these earnings gains have come in spite of significant headwinds. These include working through pre-crisis era non-performing assets, a process that's largely complete, litigation expenses for some larger institutions, and an interest rate

environment that has compressed that interest margins. To the extent interest rates return to more normal level, we will likely see improved net interest margins and even stronger bank earnings performance. We already see evidence that increases in net interest margins and net interest income are beginning to drive growth and bank profitability.

At the same time, the U.S. banking industry is supporting the credit needs of the U.S. economy. Annualized loan growth at U.S. banks during the three years 2014 to '16 averaged 5.7 percent, significantly outpacing nominal GDP growth in each year. This comparison suggests that banks are supporting economic growth rather than constraining it. Moreover, total bank loans outstanding have grown faster than loans held by non-bank sources of credit in six of the last seven years.

In international comparisons, large U.S. banking organizations, as a group, are better capitalized than their European counterparts. Yet both economic growth and bank loan growth have been substantially stronger in the United States than in Europe. Large U.S. banking organizations are supporting economic activity through their investment banking subsidiaries as well. The top five investment banks in the world, by fee income, in 2016 and the first nine months of this year, all were investment banking subsidiaries of U.S. globally systemic banking organizations.

Supported by the bond underwriting activities of these and other U.S. investment banks, corporate bond issuance for both investment and speculative grade debt has been at a record-setting pace during much of the post-crisis period.

In the secondary market for corporate bonds, trading volumes have grown steadily in the U.S. during much of the post-crisis period, which trading volumes in Europe have been flat. Transaction costs of trading corporate bonds is measured by bid-ask spreads, are trending downward, and are generally at pre-crisis levels.

The Federal Banking Agency's second quarter of 2017 staff report to Congress on corporate bond liquidly, for example, described liquidity conditions in the primary and

secondary corporate bond markets as accommodative.

The take away is that U.S. banking organizations are recording strong earnings and are supporting U.S. economic activity. The improved cushions of capital and liquidity at large U.S. banking organizations are not a source of competitive weakness relative to banks in other jurisdictions. They are a competitive strength for our banking industry and our economy, and one that is directly attributable to the strong U.S. response to the crisis as reflected in the core reforms. Moreover, it is now more likely that in the next downturn large U.S. banking organizations will play a stabilizing role rather than contributing to a deeper economic contraction.

And one final point. The strong post-crisis performance has applied across the U.S. banking industry from small to large institutions. In fact, as we've documented in the FDIC's Quarterly Banking Profiles, community bank performance during this post-crisis period has generally outpaced the banking industry as a whole. The community bank business model is characterized by careful relationship lending funded by stable core deposits, focused on a local geographic community that the bank understands well. That model has held up remarkably well during this post-crisis period.

In particular, community banks continue to play a critical role in small business finance in the United States. They hold 13 percent of banking assets, but account for 43 percent of small loans to businesses and farms. Consolidation pressures on community banks for narrow interest margins, regulatory compliance costs, IT management, and succession planning will continue. But the evidence suggests that the community banking sector will continue to be vitally important to the U.S. financial system and the economy for the foreseeable future.

So that brings us to today. This is all a setup, if I may say. Similar to 2005 when I started at the FDIC, the U.S. economy's experiencing a period of prosperity. Growth in real GDP is averaged 2.2 percent in its expansion and was right around 3 percent in the second and

third quarters of this year. Our stock market has reached new highs, and real estate prices have been rising. Global economic growth appears to be picking up, with the IMF raising its growth forecasts for Japan, China and Europe. The post-crisis economic expansion is now in its 101st month, making it the third longest expansion in U.S. history. This coming June it would become the second longest expansion. And the current consensus is that will occur. None of the economists polled by the Blue Chip economic indicators foresees a recession this year or next. This improvement in the economic outlook is a positive development for banks, and I might say for bank regulators as well.

We know, however, that economic expansions eventually come to an end. And we also know that financial shocks can come from unexpected sources at any time. Following the savings and loan crisis of the 1980s and the banking crisis of the late 1980s and early 90s, we entered a 10 year economic expansion. That's the longest in U.S. history. But even that period was punctuated by a series of domestic and international crises that tested the effectiveness of risk managers.

Banking and economic crises emerged during the 1990s and into the early 2000s in Scandinavia, in Mexico, in East Asia, in Russia, and in Argentina. Domestically, severe disruptions were averted in 1998 following the collapse of long-term capital management that resulted from its use of high-risk albatross trading strategies. The 2001 crash in .com equity prices was soon followed by the sudden bankruptcies of Enron and WorldCom. Finally, the development that would ultimately trigger the recent financial crisis was a decision by financial institutions in increasing numbers and of increasing size to enter the business of originating or securitizing sub-prime and alternative mortgages.

Such experience is a reminder that despite the good conditions we currently see, there are always challenges that could quickly change the outlook. Even though the current expansion appears more sustainable than the boon that occurred in the years leading up to the 2008 crisis, there are vulnerabilities in the system that merit our attention.

One vulnerability relates to the uncertainties associated with the transition of monetary policies both here and abroad, from a highly expansionary to a more normal posture. Market responses to changes in monetary policies can be hard to predict.

Recently the Federal Reserve has embarked on a gradual reduction in the size of its balance sheet. Thus far there's been no apparent market reaction. Nonetheless, higher interest rates could pose problems for industry sectors that have become more indebted during this expansion. By many measures, stocks, bonds, and real estate, are richly priced. Stock price to earnings ratio are at high levels. Traditionally a cautionary sign to investors of a potential market correction. Bond maturities have lengthened, making their values more sensitive to a change in interest rates. As measured by capitalization rates, prices for commercial real estate are at high levels relative to the revenues the properties generate. Again suggesting greater vulnerability to a correction.

Taken together, these circumstances may represent a significant risk for financial market participants. While banks are now stronger and more resilient as a result of the post-crisis reforms, they certainly are not invulnerable.

History shows that surprising and adverse developments in financial markets occur with some frequency. History also shows that the seeds of banking crises are sown by the decisions banks and bank policymakers make when they have maximum confidence that the horizon is clear.

It is also worth keeping in mind that the evolution of the global financial system towards great interconnectedness and complexity may tend to increase the frequency, severity, and speed with which financial crises occur. It would be a mistake to assume that a severe downturn or crisis cannot happen again.

These considerations should inform our approach to financial regulation. While the banking system is much stronger now than it was entering the crisis, continued vigilance is warranted. The core prudential reforms were put in place to address issues that helped

precipitate a crisis we do not wish to repeat.

The post-crisis reforms collectively constitute a large body of new regulation, and they could benefit from review. There is doubtless room to simplify or streamline some aspects of prudential regulation without sacrificing important safety and soundness objectives.

Examples include the prospect of a simpler Volcker Rule compliance regime, ways to reduce compliance costs associated with company run stress tests and resolution plans, and simplifications to capital rules for smaller banks.

The FDIC has been part of these discussions and will remain engaged. At the same time, the danger is the changes to regulations could cross the line into substantial weakening of requirements. And let's be clear, our largest banking organizations are not voluntarily holding the enhanced capital and liquidity asset cushions required by current rules. Some have made quite clear that left to their own devices, they would operate with less capital and less liquidity. If and when some banks go down such a path, others will be pressured by their shareholders to do so as well, to boost return on equity by operating with less capital.

A well-functioning bank regulatory system should provide a set of guard rails that allows for healthy and sustainable access to credit without endangering stability or unduly exposing the deposit insurance fund. Our aim should be a regulatory framework in which banks provide a sustainable volume of well underwritten credit that can support the economy.

Bank lending has been growing at a healthy pace that exceeds GDP growth. And the financial strength and resilience of the banking industry has greatly improved. In contrast, the unstainable long growth in the years immediately preceding the crisis and the excessive leverage and reliance on short-term funding at a number of large institutions were signs of financial system fragility, not of strength. Weakening the core reforms that apply to our largest banking organizations would increase the risk of future banking crises that would be very costly for the U.S. financial system and economy.

As I have indicated in the past, I would particularly raise a concern in regard to

weakening capital requirements for systemically important financial institutions. I refer specifically to the idea of removing central bank exposures, treasury securities, and initial margin from the calculation of the enhanced supplementary leverage ratio, and lowering the ratio. These changes would be at odds with the purpose of a leverage ratio which has served for many years in the United States as a simple unweighted measure that limits excessive leverage and compliments rather than mimics the risk-based framework.

Taken together such changes could reduce the leverage capital requirements for the eight U.S. G-SIBS, the Globally Systemically Important Banks, by amounts ranging from 25 to more than 50 percent for some institutions. The enhanced supplementary leverage ratio which currently represents a strengthening of the pre-crisis leverage requirements for the U.S. G-SIBS would for some institutions become a weaker requirement than they were subject to even before the crisis. Such a change would significantly weaken the resilience of large Systemically Important Banking Organizations and the financial system.

So in conclusion, so there's hope here. In conclusion, I was recently reminded at a speech I gave in May of 2006 at a meeting of the Conference Estate State Bank Supervisors. The subject matter at that time was Basel2, a capital framework that would have substantially reduced capital requirements. The speech included the following statement: "While we all hope that the current high level of economic activity will continue, it would be a mistake, it seems to me, to take for granted that the next 10 years will be equally benign. We should therefore be particularly cautious and prudent in making changes to our system of bank capital." It seems to me that that statement in that speech remains relevant today.

The U.S. banking industry has transitioned from a position of extreme vulnerability to a position of strength, operating with stronger cushions of capital and liquidity required by the post-crisis reforms, large U.S. banking organizations are experiencing strong earnings growth and are providing support to the U.S. economy through their lending, investment banking, and other activities. Moreover, they are better positioned to support

economic activity in the next downturn and avoid a financial crisis as occurred in 2008.

All of us have a stake in preserving these hard-won improvements in the strength and the stability of our banking system.

Thank you all very much.

MR. KLEIN: Okay, great. I'm going to ask you a couple questions and then we'll turn to the audience.

MR. GRUENBERG: Okay.

MR. KLEIN: I think first, you gotta start with the breaking news. So yesterday a deal was announced between the Senate Banking Committee Chairman Crapo and a group of eight Democratic Senators, broadly speaking, to reduce some regulation, including increasing the size threshold for banks that are subject to enhanced prudential regulation from 50 billion to potentially as high as 250 billion. What's your reaction?

MR. GRUENBERG: Aaron, I have to tell you it's not entirely a shocker that you asked me about that. And, you know, you mentioned I worked on Capitol Hill for a long time. And it's one lesson that I learned is don't comment on a summary of a Bill without actually having the opportunity to read the Bill. And the fact is, as you know, a summary was released yesterday afternoon. But we actually still haven't seen the legislative language. And in just reading the summary, there are clearly some things that create questions as to what the actual content of the provisions are. So sorry to duck you, but for purposes of today I think I'll refrain from commenting and give me a chance to take a look at the actual Bill.

MR. KLEIN: Fair enough.

MR. GRUENBERG: That's a former staffer out there.

MR. KLEIN: The devil's in the details. So let me then kind of return. In your remarks you really laid out the case of why we have to remain vigilant for high capital standards and robust regulation. As you say, guard against the temptation to become compliant.

MR. GRUENBERG: Complaisant.

MR. KLEIN: Complaisant. So there's another narrative out there that has this kind of pendulum narrative that pre-crisis we've become too complaisant, then there's a crisis and the pendulum swings to be too much toward regulation, and then the pendulum starts moving the other direction. In the pendulum argument there's always this kind of this mythical resting place of perfection that's never really described. But the kind of narrative in that arc is intrinsic that the pendulum is swinging the other way. What do you think of that pendulum argument that's wrong? What's your reaction to that?

MR. GRUENBERG: Well, you know, to a certain extent my speech is a case for suggesting that we've gotten the balance pretty good right now. I mean look, the banking industry in the United States is performing well, it's supporting the economy, lending activity is substantially faster than GDP growth in the economy, and our institutions, particularly our largest, most systemically important one, are well capitalized and strong liquidity, and are substantially more resilient than they were prior to the crisis.

So the question is: What's wrong with this picture? I mean I think in some sense this is -- you never get things perfect, but this is a reasonably positive and balanced situation. And the other point I wanted to make in my remarks was that, you know, the outlook right now is pretty positive by all the forecasts, maybe for the next year or two. But we're never sure about what the future brings and we're already in the third longest recovery that we've had in the United States. And we know at some point there's going to be a downturn. If we have our largest financial institutions in the position where they have strong capital and liquidity to support current economic activity and preserving that strength whenever the inevitable downturn occurs, that will allow the institutions to sustain their activity through the cycle.

I mean in some sense that's really the objective of regulatory policy. So, you know, I guess I'd make the case that we're actually in a pretty good spot today. And the challenge, frankly, is to at a minimum to sustain our position. Because I think that position both will support current economic activity and put us in a pretty good spot that whenever the

inevitable downturn occurs, our institution's should be able to weather it.

MR. KLEIN: You made the point at the beginning of your speech that when the financial system craters in the face of economic weakness, the losses are immense, $10 to $15 trillion, millions of people unemployed, millions of foreclosures. And the comment that having a system that can be countercyclical, that can withstand during a downward period, but at the same time you're also making the point that the banking industry today is providing adequate credit to meet demand. In essence rejecting the argument that there's some notional economic growth that's being bottled up by a failure of credit supply.

MR. GRUENBERG: You know, I mean I think the answer to that is yes. You know, the FDIC releases a quarterly banking profile, which is essentially a snapshot of the industry. So we've been following, and talked about it in the speech, the lending activity of our banks over the past several years, and the lending activity has been strong and meeting market demand. And for what it's worth, you know, we haven't seen anything in our analysis of the data to suggest that there's a supply issue on the credit side. The issue is really one of demand.

And the industry is well positioned today to meet that demand, and has been doing that well for several years now.

MR. KLEIN: Let me turn for a second on the global perspective. Because the financial crisis demonstrated the global interconnectedness of the institutions and economy which you kind of referenced as a fundamentally growing over time. And you were active before, during, and after in strengthening those global interconnections on the policy side, particularly as it relates to failure resolution, which is one of the most challenging and complex global coordination issues. But today there's kind of a backlash, a growing skepticism about the efficacy of some of those new institutions that didn't exist prior to the crisis, particularly the Financial Stability Board.

What's your reaction to that skepticism, and what do you think would happen if

we were retreated from our positions as a global leader, as some have kind of been advocating?

MR. GRUENBERG: Well, look, it's no -- I think everyone understands that finance today is deeply interconnected nationally and internationally. And that's not something that's reversible. And we saw it dramatically in the financial crisis. The crisis that emanated from the United States severely impacted Europe, in turn had consequences for us. And ultimately required extraordinary measures by the authorities in both.

And I think one of the lessons from the crisis is while we had considerable international financial engagement, it was not nearly enough to have an effective coordinated response to the crisis and to establish the international standards to reduce the probability of future events. And I think this post-crisis period has really seen an enormous deepening of the working relationships among the major jurisdictions of the world. And I think that has tremendous value.

And, look, you know, when Lehman Brothers failed was one of the triggers of the crisis. They were desperately seeking an acquire for Lehman. One of the prospective acquirers was a UK institution, was well known at the time. It's been in the press. And they literally couldn't facilitate the transaction in time. And we literally didn't have the working relationship with the UK authorities to make that happen. And it had significant consequences. And it's one of the reasons that, you know, in this post-crisis period, particularly on this issue of managing the resolution of systemically important firms, by definition these firms have global operations.

You can't deal with the failure of the firm without addressing the foreign operations of the institution, without having an ability to cooperate and coordinate with the foreign authorities that oversee those foreign operations. We have spent an enormous amount of time with the key foreign jurisdictions for the U.S., which first and foremost is the UK, but also Europe, Switzerland, Japan. And we've had, you know, extensive engagement with all of those jurisdictions. Each of those jurisdictions have passed and enacted new authorities relating to

resolution similar to what we've done in the United States. And we now have an ongoing and active working relationship.

We've actually conduced tabletop exercises at the principal level to establish the working rules for our engagement. And we now have a capability that I think we really didn't have in 2008. If one of these firms got into difficulty we can envision managing an early failure. That just wasn't possible several years ago. And an essential element of that, not the only element, but an essential one, is the ability to deal with those cross-border relationships. And that translates into other areas as well.

MR. KLEIN: So I just want to ask a couple more questions before turning to the audience. But I'd be remiss if having you on stage I didn't ask about Single Point of Entry, kind of the critical breakthrough, the committed strategy of the FDIC. For those folks who like to point to Dodd-Frank's length and draw points, do a word search of Dodd-Frank and search for Single Point of Entry. I'll give you a hint. You won't find it. There's nowhere in the statute that those words or concepts appear. In fact it was a creation of the FDIC.

Can you describe how you came to that solution and, more broadly, what implication do you draw from having come up with the solution widely held and supported, to a problem in legislation that was never actually identified as a solution by Congress?

MR. GRUENBERG: Well, you know, the Federal Deposit Insurance Act was passed in 1933. And gave the FDIC a set of authorities relating to deposit insurance and resolution. And I will tell you, there's nothing in the Federal Deposit Insurance Act that talks about something called the "Purchase and Assumption Strategy" for managing the failure of banks. But I will tell you the FDIC has now used that strategy to manage the early failure of thousands of insured depository institutions. It simply means we take over the failed bank and then try to sell the bank, in part or in whole, to an open and well-run financial institution. That Purchase and Assumption Strategy, as it were, has been part of the FDIC's work for a long time.

Single Point of Entry is a strategy developed to deal with the structure of another kind of financial company, a diversified bank holding company with large operations in the U.S. and globally. And trying to think through a strategy that would allow for the failure of that firm without unacceptable disruption to the financial system.

And when you're talking about firms of that scale and complexity, you know, that's a pretty neat trick. So your Single Point of Entry was just a strategy that we developed that would allow us to take control of the firm at the holding company, impose losses on the shareholders, creditors, and management to the firm at the holding company level, while allowing for the subsidiary firms to remain open and operating while we then proceed on an orderly process of wind down and liquidation of the entire entity.

It is a strategy utilizing the set-up authorities available under the Orderly Liquidation Authority, entirely similar to what we've had for banks under the Federal Deposit Insurance Act. There are other strategies we may employ, depending on the nature of the institutions and the circumstances at the time.

And, you know, for better or worse, the FDIC has had a lot of practice at this sort of thing over the years. So, you know, with practice you get a little inventive, and that's probably how we came up with that.

MR. KLEIN: Final question before turning to the audience. As you reflect on your time and legacy at the FDIC, what is the one moment that you'd be most proud of?

MR. GRUENBERG: I don't know. If I may, let me take the liberty of answering that my own way. It's been 12 years and, you know, my term as Vice-Chairman pretty much covered the crisis period. And my term as Chairman has covered the post-crisis period. And as I look back on the performance of the FDIC over that period, I'm not what you'd call a disinterested observer, but I do think the performance of the Agency during the crisis and then in its post-crisis period, has been a pretty constructive one.

I do think we played a key role in containing the crisis from being far worse than it

was. And I think we have in this post-crisis period, if I may say, overseeing the recovery of the banking industry, and seeing the restoration of the capital liquidity of the industry so that it is today again in the position of strength and able to support the U.S. economy. And taken together, you know, that's not a bad record.

And to the extent I've made any contribution to that, I feel pretty positive about it.

MR. KLEIN: Great. I think we have our first question over here. And then per Brookings protocol, just introduce yourself and please ask a question.

MR. SHERRETTA: I'm Robert Sherretta, President of the International Investor. We'd like to take issue with one of the things you said, and that is that the banking industry is addressing the broader economy. You celebrated the fact that small community banks with only 13 percent of the assets were contributing a great deal to the small business loans. That tells me that those institutions with 87 percent of the assets aren't doing enough of a job.

But more to the point, when we get through the annual reports and the 10Ks of these institutions we see a reliance coming again on proprietary trading for their earnings and profitability. We see an awful lot of lending for the sake of stock buybacks. We see a lot of loan activity to hedge funds. We see a lot of loan activity to private equity. And we see an increasing amount of international loans. All that tell us that there's a certain degree of risk building again.

So I wonder if you could address that. And my final point being that during the crisis many of the investment banks of Wall Street became automatically holding companies in order to qualify for some of the Federal Reserve and Treasury bailout monies. Do you believe that that has become too broad a designation? And should Congress and we consider reining back that broad label of holding company which gives them access to taxpayer funding?

MR. GRUENBERG: I think you've got several questions. Let me say, in some sense I'm agreeing with your core point, which is there is risk in the system. And we need to pay close attention to it. And even though the economic environment today looks pretty good,

the risks are there and will likely evidence themselves at some point.

And, you know, history suggests we don't know what's going to cause the next set of problems, but at least maintaining the prudential cushions that these institutions, their capital and liquidity that we've built up in this period, so that whatever may develop, the institutions are in a relatively robust position to manage. It seems to me that the threshold thing for us to do.

And then we could also spend some time trying to figure out, you know, where the next problem is going to come. Realizing that chances are we may not spot it, and at the minimum we ought to position ourselves to manage it as effectively as we can with as little disruption to the financial system and the economy as possible.

MR. PEROUSKI: Yes, I'm Ed Perouski, Voice of Noise Foundation. When you had reduced risk weight capital requirements you allow the banks to leverage differently on different assets, which produces a totally different set of risk adjusted returns on equity than if you did not have risk weighting. Are you never concerned about the distortions that have been introduced by this into the allocation of bank credit to the real economy? I mean, if we cite John August Shedd, he said "Boats are very safe in the harbor, but that's not what ships are for."

So the allocation of credit, when is that coming up?

MR. GRUENBERG: You raise a point that I mentioned as well in my remarks. I think risk-based capital has a role to play because it does attempt to measure the risks sensitivity of assets, and that's something that should be taken into account in establishing capital levels.

But frankly, there's a lot of risk in relying exclusively on risk-weighted capital. Because experience has shown us, and it showed us during the crisis, that frankly we can get the risk weights wrong. And that's part of the point that you're making, with significant consequences. And so you really want to balance risk-based capital with a substantial leverage capital requirement, which is a simple non-risk sensitive but loss-absorbing measure of capital

that can support the institution.

And frankly, one of the lessons we learned from the crisis was during the most severe times of stress, the financial markets really looked to the leverage capital because they knew they could rely on it. So maintaining that as a complimentary measure to risk-based capital seems to me to be the best foundation for a capital system.

MR. KLEIN: There's a question in the back, and then we may go to a speed round.

MS. GUIDA: Hi. Victoria Guida from POLITICO. I wanted to ask, hypothetically, how you would feel about exempting banks from the Volcker Rule that have fewer than $10 billion dollars of assets and total trading assets and liabilities that are less than 5 percent of the assets. That's my first question.

And my second question is do you plan on staying on as Chairman until your replacement is confirmed?

MR. GRUENBERG: So thank you for the question. If you don't mind I'll answer the second one first. I gotta tell you, that one's not entirely a shocker either.

So, you know, as you probably know my terms as Chairman expires at the end of this month. And under the Federal Deposit Insurance Act I can continue to serve until someone is confirmed to succeed me as Chairman. So it would be my intention to continue to serve until someone is confirmed to succeed me as Chairman.

And in regard to the second, I've been more inclined toward a safe harbor rather than an exclusion. Most community banks don't engage in activities subject to the Volcker Rule. And a safe harbor for the vast majority of community banks seems to me a reasonable approach for those who don't engage in the activities. And you just want to be a little careful that you don't allow that to be a vehicle for that kind of activity, which is probably why I'd prefer perhaps a safe harbor than an exclusion.

MR. KLEIN: Okay. Great. We just have time for one or two, so let's just pass

the mic. Allen, and then behind. He's been waiting, and then we'll do a speed round.

MALE SPEAKER: Thanks. Excessive leverage is a source of fragility throughout the economy. And as you pointed out, banks don't willingly hold the levels of capital that they hold today. And when I think about that it's clear to me that the tax system is part of the culprit.

The tax system, because of the way capital gains are taxed versus the way dividends are taxed encourages excessive leverage. And there's a big debate going on in the Congress over taxation. And for example, instead of an across-the-board cut in the corporate income tax, if dividends were removed from double taxation, and that is if dividends are not taxed at the corporate level but only at the recipient level, it would reduce the cost of capital and reduce the unwillingness of banks and other institutions to hold capital.

So what do you think about having the FDIC weigh in on that.

MR. KLEIN: So hold on. We got in the back. Sir, we're going to do the speed round. Keep going.

MR. GRUENBERG: I'm going to lose track of these questions.

MR. GRAY: I'll try to keep it simple. Richard Gray from the Institute of International Finance. Thank you for your comments, Mr. Chairman.

And you spoke about the value and importance of the measures post-crisis measures in particularly the international regulations and international cooperation. The FDIC is a member of the Basel Committee, which promulgated many of those reforms. But the finalization of the Basel Reforms has stalled, coming down to largely the output flow, but another issue that's emerged is the commitment of the U.S. to implementing those reforms.

And there was a speech by the Governor of the Bank of France just last week specifically calling that out as important. So that total commitment of all the members, institute, organizations. I'm just interested in your views on that Basel process and finalizing it.

MR. KLEIN: Okay. We got one more third question. He's been waiting patiently.

And then we'll let you pick one of them.

MR. CHUNG: Hi, there. Brian Chung with S&P Global Mark Intelligence.

So I knew you won't speak specifically to the Senate Bill, but in your speech you do mention that you can get behind the simplification of capital rules for some sizes of banks. In your view, I mean what would be, I guess, the best approach for capital requirements of banks of different sizes and where do you think the line should be, is $50 billion okay?

MR. KLEIN: So here are the questions.

Allen's question on double taxation of dividends.

Question from the IIF about Basel being stalled and what's the commitment of the U.S. And from Brian and S&P, what's the best approach to engaging in simplification of capital rules. Pick your favorite.

MR. GRUENBERG: So taking them in order, if I may say it, I have enough trouble with financial regulation policy, I don't think I'm going to enter into the tax policy debate today, if you don't mind.

On the second one, on Basel. You know, we've said this before, but I think we're closing in on a finalizing an agreement, and I think the U.S. is prepared to follow through on its commitment.

And on the simplification of capital, I think, you know, my remarks have particularly focused on the simplification of small bank capital. And the banking agencies have put out a notice of proposed rulemaking to address some discrete issues relating to small bank capital, particularly dealing with something called HVCRE, High Velocity Commercial Real Estate, which is, as you know, been a source of particular concern to the community banks.

And I think going beyond that package, looking at an approach for community banks under $10 billion, where if they are strongly capitalized on the leverage ratio and don't engage in a great number of risky activities, I think there is room to deem them in compliance with risk-based capital. Which I think would be a significant measure of regulatory relief for

those institutions. So I think that's an approach worth looking at.

MR. KLEIN: Right. Join me in thanking Chairman Gruenberg for his time here.

I would call the panelists to the stage. Let me take this moment to also, in addition, to acknowledge that Davis Polk provides support for economic studies program and reiterate Brookings' commitment to independence, as well as to underscore the views expressed today are solely those of the speakers.

Speaking of which, allow me to turn over my moderating duties of this conversation to Deborah Solomon, who's the Economics Editor at the New York Times. She previously spent 15 years at the Wall Street Journal where she oversaw financial regulatory coverage, including Dodd-Frank. Prior to that she covered the financial crisis and Washington's response to its aftermath. Deborah, thank you for joining us today.

MS. SOLOMON: Thank you. And I will introduce our other panelists. Next to me is Don Bernstein. He is the head of the Restructuring Practice at Davis Polk, and works with a lot of the banks that are under the FDIC's purview and are dealing with resolution authority that Chairman Gruenberg had spoken about.

And Jeremiah Norton, who was on the FDIC with Mr. Gruenberg. He's now the Managing Partner of Chain Bridge Partners, and has had a long career in Washington working at the Treasury Department under Henry Paulson, worked through the crisis, and is well aware of all the issues facing banks. And now works with financial institutions on regulatory issues.

And you know Aaron, I won't introduce him. So we will have to do a little bit of speed round because Don actually has to catch a flight back.

But I guess I'm curious, you know, there seems to be a see change in Washington now, obviously, with the Trump administration coming in. Both Janet Yellen, and now Chairman Gruenberg, have warned against complacency, saying that we've struck the right balance. You know, things may not be perfect but they are as close to perfect as they're going to get. You know, how concerned should we be about sort of this complacency idea that things

seem pretty good right now so maybe it's time to loosen the chains a bit.

I'd be curious, Don, to hear from you since you work with banks, you know, do they feel like there needs to be some relaxation or do they feel pretty confident that they've gotten this as right as we can get it?

MR. BERNSTEIN: So I don't think it would be any surprise to say that they think there should be some relaxation. From my perspective, which is to look at the resolution side of things, we have developed now a set of tools which was discussed, you know, with Chairman Gruenberg of this Single Point of Entry tool. And we've spent a number of years now trying to perfect that.

And the thing that's interesting about it is it resembles our Chapter 11 in that what it does is it converts debt to equity and permits losses in the banking system to be passed to the private sector. And the key to doing it is doing it quickly enough so that the bank can stabilize.

And this is a real innovation, and in and of itself is something that justifies reevaluating all the prudential regulation that we've put in place. Because we didn't have that tool. So I think that is a perspective that some of the banks have.

MS. SOLOMON: Aaron, what's your view on sort of where we are in terms of the pendulum that you spoke about?

MR. KLEIN: So I think it's important that we embrace failure. And I think I will be a lot more relaxed when we've had the opportunity to try Single Point of Entry and make sure it works.

You know, we have 6,000 banks in America today. If none of those banks fail over the course of a normal year, I think that's a giant problem. I think the goal of regulators should not be zero failure. I was struck by Chairman Gruenberg's remark that the longest period in American history without a bank failure, were the two and a half years leading up to the crisis.

And so, you know, what I worry about is having the wrong set of goals as financial stability mantras kind of come in. This idea that a period with no failures is success. You know, if we had 6,000 restaurants that didn't fail in a given year and you came back to a city and every single restaurant was still around, to me that's not the mark of a healthy economy.

MS. SOLOMON: Jeremiah, I'm curious since you're with FDIC, if you share that view or if you think that having, you know, a limited number of bank failure is a good idea or if that's a mark of a problem in the system?

MR. NORTON: I don't want to speak for Aaron, I don't think he's rooting for mass failure. But I think in any market if you're not seeing, you know, the strong thrive and some weak go away, that it's probably a sign of something askew. So I'd agree with that general direction.

And on the overall environment of where we are and where we might go, I would say it's still early to tell as the new administration appointees are either just being seated or not confirmed, or even not yet nominated, in the case of Chairman Gruenberg's successor. So I think it's a big early to tell.

As one of the questions alluded to, we are starting to see some activity in the Congress with news from the Senate Banking Committee and some members yesterday. I don't think there's a general approach that we can't have reform. I think the question is how far you go. I would be of concern if some of the prudential standards were eroded considerably because I think they were needed. So I think we'll have to wait and see.

We at least know with the leadership that, in my personal view, at the Federal Reserve that's been either in place with the new Vice-Chair or the Chair Nominee in Jay Powell, we have people with experience and that I would consider quite thoughtful. So that gives me some comfort that the ship will governed from a policy standpoint from people that I don't think that would be radical in scaling things back.

But I think overall, having enhanced prudential safeguards makes sense given where we were a few years back.

MS. SOLOMON: I'll come back to the Fed in a minute. But I'm curious, you know, the banking system is demonstrably stronger today than it was pre-crisis. And Chairman Gruenberg talked about the, you know, sort of how banks are contributing to the economy. The statistic he gave was a 44 percent increase in earnings since 2011.

So if banks are doing fairly well, even with all the capital constraints and all the rules and the regulatory burden that they say they have, why do we need to, you know, why mess with perfection? Right? What is the rationale for doing away with rules that don't seem to be impacting bank's ability to lend and grow? Don.

MR. BERNSTEIN: I'm not an economist, and I'm not a financial advisor, so I'm going to defer to the people on my left.

MR. KLEIN: I guess I'd say this, right. As an economist, I don't like unindexed numbers. Though the $50 billion SIFI threshold number is not indexed. It's not indexed inflation, it's not even indexed to economic growth. As Chairman Gruenberg made the point that, you know, you want to think about loan growth as it relates to nominal GDP actually. So, you know, speaking strictly for myself, you would think that you would want to create indexations or think of concepts and numbers as they relate to nominal growth in the economy. Failure to do that means that you're actually on a real basis, lowering the threshold over time.

So I don't subscribe to the idea that Dodd-Frank came down from Mount Sinai on stone tablets never to be altered. I think if you look at some of the numbers baked into that, neither would they. But I think there are also a lot of productive areas to address that aren't part of Dodd-Frank. I think part of the problem in our current debate is Dodd-Frank has become this catchall for bank regulation. In fact the preponderance of bank regulation exists outside of the four corners of the legislation. The Wall Street Reform and Consumer Production Act, known as Dodd-Frank.

So I mean there are other things out there on money, anti-money laundering regulation that's continued to grow, currency transaction reports, a number that's been nominally stuck at $10,000 since 1970. I'd like to say that you could have bought a brand new Cadillac in cash and not triggered a currency transaction report. Today you can't buy a Ford Focus. This is what happens when you don't index numbers over time.

So I think there are important areas to always be evolving and relooking at. And I think the conversation's become too narrowly focus on Dodd-Frank.

MR. NORTON: Yeah, I'd agree there are areas. First of all, the macro environment that Chairman Gruenberg described is hard to argue with. The U.S. financial system has healed very quickly. I think when you look at market share statistics, U.S. firms have done quite well versus some of their global peers, over the past number of years, even with higher capital standards that we have in the U.S. So I think the premise of the point you made in the speech has a lot of merit to it.

But I'd also say at any time there's a huge statutory process, and Aaron and I were up on the Hill in our careers, there is room to refine, recalibrate, examine what's been done. And I wouldn't just hold that to Dodd-Frank. I would say we ought to be looking at where we are periodically. We're in a position of strength now to be doing these things. So it seems like a good time to look at things, keeping in mind we shouldn't forget about what could be on the horizon from a risk standpoint.

MS. SOLOMON: Well that's a good point. I mean obviously we had the Chairman of the FDIC here so he's very bank focused. But I'm struck by how, you know, so close after the crisis we are still talking about banks as a source of systemic risk. And you've seen the Financial Stability Oversight Council now, kind of scale back on their SIFI designation for non-bank financial firms.

Are we missing the forest for the trees? I mean are we not actually taking stock of what other risks are populating in the financial system outside the banking system because

banks, you know, were the source of so much focus in Dodd-Frank, but AIG and other financial institutions, you know, were supposed to be also looked at in terms of their ability to cause systemic risk and systemic problems.

You know, Aaron, I guess I'm curious from your perspective whether you think we should be looking outside the banking system, you know, as we're sort of maturing and getting past kind of the initial period where we needed to get the bank stronger. Shouldn't we be looking more towards other areas of risk versus just trying to go back and fix what we think got wrong with the banks?

MR. KLEIN: So, Deborah, it's important that you raise that. When you look at the history of sub-prime mortgage lending, which Chairman Gruenberg kind of identified as the kernel from which the crisis grew and exploded, that started outside of areas of the banking system and then really grew within the thrift system of the banking system, and ended up infecting the entire system.

I'd say that there are two different problems. The first is a nomenclature problem. When we use the word "bank" we tend to really usually generally mean commercial bank. Investment banks, a question asked before, became bank holding companies, were involved in the crisis, were also banks, but were structurally separate. When we allowed the merger of commercial and investment banks under Gramm-Leach-Bliley, which functionally repealed portions of Glass-Steagall, we never really updated our nomenclature. So we used this term "bank" very loosely, when we really mean radically different constructs.

And so I think something will exist within the financial system defined broadly by commercial investment banks and insurance companies, kind of the regulated financial system. And I think that has to be the first moment of vanguard.

I do think there's a structural change that's occurred with the new guard that kind of Jeremiah's talking about, and that started with the kind of the Financial Stability Oversight Council's decision to rescind the designation of AIG.

Which for those of you may recall, happened on a Friday afternoon right as Yom Kippur was starting. It was literally I went into Synagogue to atone for my sins and I came out and AIG had been forgiven. And, you know, okay, I get that. AIG today is not AIG of 12 years ago. And designating an individual company, at what point, you know, should their sins be forgiven. It's not in perpetuity.

But the new Council's kind of set as its mantra, not that designation of individual institutions, but going after activities and practices. Okay. To me that's a very viable and electrical framework, maybe even a superior framework to designation. But now show me the money. What activities and practices are you concerned about, how are you marshalling the Jedi council of regulators that constitute the F Stock to effective guard against these. And how can you actually implement that? Because it would be a mistake to de-designate institutions and then not aggressively police activities and practices which then pop up in institutions.

MS. SOLOMON: Jeremiah, since you were at the Treasury during the crisis, I'm curious for your perspective on whether you think that there are areas outside of the banking system that are still, you know, potential sources of risks that we should be looking at rather than talking about just, you know, releasing banks from --

MR. NORTON: So I'd start by saying there are clearly risks outside the banking system. I think my perspective on this is more of guarding the banks to let others grow through bank balance sheets. And prior to a number of reforms there were other areas that really did not make a lot of sense that I think led to some of the risks in the crisis era. Like a floating non-asset value or an automatic one dollar net asset value. So you had money markets being funded with different risks, but they got to say everything is worth a dollar, until it wasn't. So I think that contributed to funding outside of the banking system. A mistake, in my view, that that was allowed to be the case.

A lot of other institutions were funded really through prime brokerage, which in some cases originated from broker dealers, but in other cases originated from banks. So I

think, and this may be my personal view, but looking at where the banks or the government, maybe through FANNI or FREDDI, you're allowing markets to grow. That should be the lever that we're constraining. And if there are institutions outside of the regulatory space that want to fund themselves with equity or through market rate debt investors, I'd rather focus the government's attention on where the safety net's more exposed because that's a big enough problem as it is.

MS. SOLOMON: On that exposure, you know, there's been a lot of talk about the Orderly Liquidation Authority and whether or not that should be sort of thrown out, and we should resolve the failing banks through the regular bankruptcy system.

You know, Don, we talked a little bit about this before. What are the bank views of Orderly Liquidation Authority, and do they see this as a viable mechanism for resolving themselves if they get into trouble?

MR. BERNSTEIN: So let's back up and just talk about the differences between Orderly Liquidation Authority and the bankruptcy system.

The bankruptcy system as currently constituted, has the absence of certain tools that led us the Lehman situation. One example is that the bankruptcy code has safe harbors for the close out of derivative contracts and repos and other market instruments. And what that leads to is an implosion of a book which probably has few losses in it when it's an operating book, but implodes when you have collateral that's just sold on to the market, and that then has a contagion affect by reducing asset prices. And that's just one example. It's also a slower process.

And one of the challenge in the Living Wills has been doing work around for each of these problems. There's a new set of contracts where counter parties are obliged to waive their closeout rights so that you deal with that problem. There are procedures that have developed to expedite what goes on in the bankruptcy proceeding by having clean holding companies with sufficient TLAC and using this Single Point of Entry process which forces the

losses up to the holding company so that they can be absorbed by the private sector and losses can be recapitalized at the subsidiary level.

But it is a slow process and the other thing that's absent from the bankruptcy code is any liquidity reinforcement. It all has to come from the private sector, which is very difficult during a crisis.

So those things are actually in Orderly Liquidation Authority. Orderly Liquidation Authority is quick because it has the ability to regulate or to make a quick decision and do what needs to be done. It has the protection of the derivatives and other market instrument portfolios, qualified financial contracts. It also has the orderly liquidation fund which is a source of bankrupt liquidity. So having that as a second option, as a backup option, is very important.

Now the other thing is the issue of foreign regulators, which was mentioned in the comments by Chairman Gruenberg. And foreign regulators really don't understand bankruptcy that well. It's been an education process, they're starting to understand it, but the truth is that all the good work that the regulators have done in developing means of communication with regulators in other countries are helpful in the fact that the regulators can step in with Orderly Liquidation Authority as a backstop gives the foreign regulators the confidence to cooperate in any financial institution failure.

MS. SOLOMON: So do the banks like OLA?

MR. BERNSTEIN: I think the banks believe it should not be repealed.

MS. SOLOMON: Jeremiah, I'm curious. You know if we did get into another Lehman type situation, do you have confidence that the current structure would prevent the type of fire sale destabilization that we saw in 2008?

MR. NORTON: I think if we're back to an environment of September of 2008, I'd be hard pressed to say I have full confidence that the regime in place would work as we all hope it could work. That was a pretty extreme time when funding had pulled away considerably from almost every aspect of finance. I think the argument to counter that would be a lot of the

measures we've put in place would prohibit us from getting all the way to a, you know, September 14th, 2008 scenario.

But in a way these things, in my view, are binary, either it works or it doesn't. So we can make a lot of progress and it could keep us from getting to that abyss, but if you're not completely confident as a policymaker that it will work smoothly, I do believe that most people get in those seats and fear takes over and requests for unusual things starts to pop up and it starts to sound good because it's something you can control.

Now a Title II does give the supervisory and Treasury community more authority in a crisis for sure. But if they're in a situation where they're doing that for more than one entity, I think it would probably result in request for additional extreme powers. But it's hard to know because as Aaron said, you know, we haven't tested these things yet. And I'm not trying to discount the considerable work and improvement that's occurred. But you asked in fall 2008, I'd be a bit worried about testing everything again.

MS. SOLOMON: Aaron, I know you mentioned the, you know, yesterday we were chatting about Treasury looking at the Orderly Liquidation Authority. What do you expect to see out of Treasury in terms of refining that or what are you worried about in terms of there?

MR. KLEIN: I'm worried that Congress is going to repeal Orderly Liquidation Authority for the worst of all possible reasons. Because it's a budget gimmick, and Congress loves budget gimmicks. So Orderly Liquidation Authority, repealing it does not save taxpayers money. However, the Congressional Budget Office, under the rules set up to "score what costs and what doesn't cost" uses an artificial 10-year window. And under that framework if there's a crisis in the year nine or 10 when money is put out but not yet recouped, because everything is ultimately recouped, but it artificially cuts off so it appears to cost people money under a given timeframe, thus its repeal pretends to save people money. It doesn't save a penny.

So repealing it as an offset is actually the worst of all possible worlds. Most importantly, you take away a tool that could be incredibly useful in mitigating a financial crisis,

though inability to mitigate it costs trillions of dollars in the real economy, hurts millions of families, causes unemployment, and actually increases the deficit. And then you use fake savings to justify some other expenditure that itself increases the deficit. So it's like this great lose-lose.

But, you know, the ability of a budget gimmick to attract attention, coupled with an ideological opposition to having these necessary set of tools just gives me long run kind of concern as a ongoing political matter. Which is why I think it's incredibly important to constantly be hearing points like that that Don's raising, is that the intrinsic value of this. Because even though it costs taxpayers nothing, its repeal would cost taxpayers a lot, but the incentives in Congress are not aligned to recognize that reality.

MS. SOLOMON: One of the things that Chairman Gruenberg talked about was the supplemental leverage ratio, which I know sounds incredibly boring, but it's really interesting because there is a debate among even financial regulators about whether or not it distorts markets and provides the wrong incentive. So the nominee for Fed Chair, Jay Powell, has talked about potentially needing to tweak the enhanced supplemental leverage ratio, saying that, you know, he wants to make sure that it's not actually dis-incentivizing banks from getting involved in safer assets and using central clearing because the supplemental leverage ratio is a flat ratio, it's not based on risk, you know, so it doesn't matter if you have mortgages or if you have CDOs, it's the same, it judges those the same way. You know, Chairman Gruenberg seems to be very concerned about changing that, that, you know, he sees this as a very important protection and something also for the markets to look at in terms of judging the stability and safety of the banks.

Jeremiah, I'm curious, you know, given you were at the FDIC when this was put in place. What is your view of, you know, the enhanced supplemental leverage ratio? Do you think it is distorting markets and should be looked at to be recalibrated, or do you think it's serving its purpose.

MR. NORTON: Well I supported it when I was on the Board of the FDIC. I'd be more concerned about the risks that we're consolidating central clearing than I am with the distortions from anything that the supplemental ratio is causing. So if I were in a policy seat today I'd probably be more concerned about the risks that we're now aggregating in a few areas of central clearing, as opposed to the potential behavior changes that the SLR may have resulted in forcing.

So as I look back on my experience at the Treasury Department during the crisis, my recollection of events is similar to Chairman Gruenberg's in that everybody was looking straight through to TCA to TA, said what's people substantial common equity and let's judge people on that number. So I think that there's a lot of value to having a real leverage ratio in our financial system as part of the regulatory apparatus.

To say that it should never be looked at for calibration, I would never make that argument. But I do think if you're going to have one, it should mean something. And when you start to put risk matrix in the leverage ratio it's sort of an oxymoron. I feel it doesn't really make a lot of sense, in my view, to do that.

MS. SOLOMON: And, Don, I mean some of the banks that you work with must -- some of them benefit from this and some of them are disadvantaged. Do you get the sense that this is targeting the wrong type of bank? I mean I know you're not going to talk about clients, but like a Wells Fargo would have to have more of this, you know, could potentially go into more risky behavior because of their overall asset size. And isn't there sort of a weird incentive here to load up on risky assets because you're judged equally?

MR. BERNSTEIN: As a lawyer I think I'm going to beg off on this one. But I will say that one interesting thing about the debt TLAC, which is the debt that you would convert to equity, is that that's just a fixed amount. And once you have it on your balance sheet, you have it and it's available. So in a way, whatever the capital ratios may turn out to be, the ability to, in a real crisis where you've got a failing firm, convert that to equity is extremely helpful. In fact,

much of that debt existed in 2008 but there just wasn't a tool to quickly convert it to equity.

MS. SOLOMON: Well I'm going to try again then on the Living Wills. So again, the new Fed nominee, Jay Powell, has talked about potentially extending the life cycle of the Living Wills. Right now banks have to file them every year. He talks about maybe there's some reason to, you know, do it bi-annually. These are obviously quite large filings the banks have to do every, you know, every year. They spend a lot of time.

What is the view from Wall Street in terms of both the efficacy of the Living Wills and whether, you know, doing it on a bi-annual basis would serve the same purpose. You know, I feel like a lot of the banks feel like this a good exercise even if it is, you know, a pain.

MR. BERNSTEIN: Yeah. So I can't speak for all of Wall Street, I can give you my personal perspective having worked on these.

The amount of effort that goes into them with hundreds, and sometimes even thousands of employees at these institutions, because you've got to deal with every single entity in the institution to create a Living Will, is enormous. The amount of effort that goes into evaluating a Living Wills that the regulators have to do each year is enormous.

So extending the life cycle of these things, especially now that we've reached the stage where the requirements are pretty well defined by guidance that's been given by the regulators, and the plans themselves have been updated several times to meet that guidance, makes a lot of sense.

I do think that the process of having people understand the institution has been valuable for most of my clients. And so I don't think that, you know, that the process is a wasted process, but it is an extraordinarily expensive. And now that we've gotten to this point, a cycle that's a little bit longer makes a huge amount of sense, both in terms of the perspective of the institutions and from the perspective of the regulators.

MR. KLEIN: Sometimes when you create things by analogy it's worth sticking with the analogy. Right? So creating a Will is a really important thing that most people should

do in their life. And in the process of creating that first Will you may come across some issues that you hadn't really recognized, and takes you a year or two or some amount of time to work through to get that first Will exactly where you want it. After that you probably don't need to renew your Will on an annual basis going forward. You probably do it when you have a major life event, when something big changes. So, you know, whether it's a periodic fixed term or whether once the institution's worked their way through on the first one, whether it's just a large merger or change in business model or growth, something that changes, then you ought to do that regardless of when it is in your term. If you say "Oh, I'm only going to look at my Will every five years," but then you get married. Well, maybe, you know, then you adopt a child, right? Like any major change in your life you should look at that.

I think that's a useful perspective to bring into this example in Living Wills in financial institutions.

MS. SOLOMON: What's your view, Jeremiah, do you agree?

MR. NORTON: I generally agree with both comments. I do think elongating the process at this point in the cycle is a very reasonable compromise, if you will. And there's a lot of work that goes into it from the firm's part and those agencies that are reviewing the plans. So I think that it makes more sense to stretch it out.

And I also agree that you can amend your Will if there's an event of materiality that would occur in your business. There is something to the fact that you make a personal Will and you die, you've executed on the plan. There are things that the firms need to do to be capable of executing their Living Wills that does take some work sort of in between plans.

So I think there is some rationale to have a process that is a bit more than one or two filings and then you're sort of done until materiality event occurs. But having a bi-annual cycle with a materiality cause, I think is not a bad place to be.

MS. SOLOMON: The other question I wanted to ask was, you know, obviously the US is just one country. You know, there are a lot of other regulators out there. And given

with what we're seeing with Brek-Fit, you know, how concerned are the banks about sort of the lack of harmonization. I know Chairman Gruenberg said that there's been a lot of progress made, but is there more of a, you know, fracturing of regulatory rules now that you have the EU and the UK and, you know, different places. You know, what are we seeing in terms of the ability of governments to really come together and harmonize rules that, you know, have been a long time in the discussion phase?

MR. BERNSTEIN: Well I think there are some divergents that are currently being debated. One example is the level of what is called "internal TLAC," the ability to have a bailinable debt at subsidiaries and how much there should be. And there's a debate over how much is enough, how much is too much, and of course local regulators would prefer to have as much in their country as possible. And that creates a tension because if you've got a global financial institution and you don't know where the problem's going to be, you need to reserve those resources somewhere higher in the corporate structures so that you can actually solve problems wherever they may be in the system.

And the solution the US has adopted is by taking resources and having contractual requirements that they be deployed where the problem is. And that's something that I don't think is universally accepted at this point by non-US regulators but an important difference that needs to be resolved.

MS. SOLOMON: Aaron, do you think we're sort of in a global race to the bottom for regulation?

MR. KLEIN: I'm not sure it's a race to the bottom as much as it is a race away from each other. And I'm concerned about this because I think, you know, you have to look at things Breck-Fit, what kind of Trumpism, you have to look at this as a broad reaction to the globalists.

And, you know, one of my favorite statistics is 62 percent of Americans do not have a passport. And that's about going to Canada and Mexico now. Oh, that's a bunk sack

because -- 62 percent of Americans don't have a passport. Do those same folks appreciate that the official Bank of the National Basketball Association is a Spanish bank? Right? What we think of as American institutions and American entities, are really global.

As Chairman Gruenberg said, you know, most of the large financial players, whether they're American based companies that operate globally or global companies that operate in America, we are an integrated global financial world. You can like that or not, you can want more sovereignty in rules or not, but those things have tradeoffs and consequences. And you can't have it both ways.

So I mean I'm worried that there's a belief within the inoculated financial services community and financial world in general that appreciates the global inter connectiveness that has passport adoption rates close to 100 percent. That somehow this talk of a national sovereignty and push back against the globalism ends at Basel's edge. And that once we're all together in the atmosphere of Basel or the international bank regulators, kind of this "sensibilities with the globalists" come back to being supreme.

I don't think that's true. I don't think the politics underlying that are stable at the domestic level. And I wonder going back to kind of the framework Jeremiah was thinking about in 2008, we did a lot of things to stabilize the global economy that, you know, today I think would come under incredible scrutiny as part of this back lash that we're somewhat, not ignored, but there was so much going on that folks didn't really fully appreciate or delve into where was all the support for AIG? What global financial institutions were really the counterparties there? What was going on with the extension of swap signs between the U.S. central bank and global central banks?

So I'm very concerned about that and I tend to just kind of hope that we won't get a crisis on the watch of the non-globalists.

MS. SOLOMON: Jeremiah, what's your view before we --

MR. NORTON: A slight editorial before answering your question.

The guest of honor today, I would say does not get enough credit for his role in facilitating coordination with the foreign counterparts in the bank regulatory and resolutions space. And it was really a concerted effort that Marty made, and with a lot of success, and I think all for the good with multiple jurisdictions. And it wasn't an easy task. So I think his service has left a lot of progress in that area.

Now I would pivot to the point Aaron made. I think the U.S., sitting here as a U.S. citizen in Washington, DC, sounding parochial at this point, but it's a little harder for US policymakers because when they're stressed, the U.S. actually funds the rest of the global system. At least in this time in the world history it's a dollar based financial system. And so the put is on really the Fed, and the dollars went out. The dollars went out in a big way, and Aaron made a point, not just through facilities, but in other measures as well, to support global banking organizations.

One of the cross currents that I felt when I was in the government was that people talked about cooperation, and yet their actions were often counter to that. They were, across the globe, biased towards ring fencing in their own actions, but in their speeches and meetings and talking points were talking about the need for flexibility and trust. And so it's hard to know if you're sitting there either as a manager of a financial institution what's going to happen, or if you're sitting in a seat in the U.S. or in Brussels or in the UK, gosh, what are these people going to do. I would say the global political environment is probably less receptive today to trust.

And the point about ring fencing, you know, if all the money's at the top of the house and flexible, that is the most efficient and makes a lot of intellectual sense. The counter argument is if you preplace considerable amount of money in different jurisdictions would that make it less likely to have a grab. Because if you give someone 80 percent of what they need they're pretty comfortable.

So I think that is the push and pull that's occurring with policymakers today. And

my own suspicion is that trust is probably more eroded today than it was a few years ago, which raises more risks for ring fencing and makes resolution more difficult.

MS. SOLOMON: Well I want to open it up for a couple of questions if anyone has anything to ask the panelists?

MR. BARRY: Hi. I'm Dan Barry, Atlantic Policy Solutions. I want to ask you guys, the financial crisis passed and Dodd-Frank regulations started coming about and the Basel3 process. It was done kind of piecemeal with the capital requirements, the leverage requirements, the resolution authority, the Living Wills. And do you feel enough was done to look at things holistically rather than looking at each piece and saying "This is the level we need here to get stability, this is the level we need there to get stability?" Did we go from instead of having an adult in suspenders approach to having belt and suspenders and rope and pulley and tape and glue and so many other things?

MR. KLEIN: I guess I could say the following. There's another way to look at Dodd-Frank. Which is to subdivide Dodd-Frank between everything that's kind of Dodd-Frank and everything that has its own name. And if you have your own name, everything that's just Dodd-Frank without its own name, kind of works together in an intellectual framework. You can agree or disagree with the framework, but they're all kind of complimentary. Title I kind of works with Title II, 165, 47. It kind of makes sense.

Then you have these other things that are important but not necessarily cohesive with the core framework. They tend to have other amendments. Cardin, Lugar conflict mineral rights, Durbin swipe fee, the Volcker Rule, the Lincoln Amendment, known as Swabs pushout, which has been functionally repeated. They're kind of alternative ideas, they were tacked on to Dodd-Frank.

Dodd-Frank is unique among America's banking laws, both regulatory and de-regulatory in being essentially a narrowly passed piece of legislation. Exactly 60 votes in the Senate. And one of the tradeoffs of not having a broader consensus position was everybody

who had a name got their piece of the pie. So in some sort of like ephemeral, theoretical, economist maximizing world, maybe it's some sort of non-existent broad consensus on a cohesive narrative that then boxed out alternative ideas that may have been good or bad in their own right but weren't core to the narrative.

In the real world where you were faced with a binary choice of legislation or not, and the ramification of the lack of consensus on a broader bases was accepting each of these little things because usually somebody's name meant their vote, that's how you ended up with where you had.

You know, maybe that's not as satisfactory an answer as one would like, but I think that's the honest description of what transpired.

MR. NORTON: My own view at the time there was too much going on post legislation passing and the implementation stage to have a coherent perspective on how it should be done. There were so many mandates on all of the financial regulatory agencies to pass rules in a quantity that really none of them could handle, and none of them had really ever seen before.

I remember a quote, I think Chairman Greenspan said "The Fed has required post-Dodd-Frank to pass more rules in two or three years than my entire term as chair," which I think was 16 or 18 years. So it was a race of epic proportions even though it seemed like it takes forever from common process to final rule.

There were so many going on and there's a limited number of people in each agency policy apparatus, and then it's complicated when you have -- adding one agency to a rule making does not make it linearly more difficult. It's really exponentially difficult even if it's just three banking agencies. And then you add a commission or two on the CFPB, a new agency, starting an agency and then doing rule making, not easy task.

So I think the sheer volume may that a difficult task, and that's why I don't think you get push back from many people to say it's healthy to look at where we are today. And

while we may be in a good place, that doesn't mean we couldn't have it in a better place.

MR. MCDONOUGH: John McDonough, U.S. Treasury, Office of Financial Research. So I wanted to follow up on something that Aaron said, but I'd love to hear thoughts from all three panelists.

So you're talking about as an economist you don't like non-indexed numbers and the 50 billion threshold wasn't indexed to loan growth or inflation or anything like that.

In Europe and elsewhere internally there's an approach similar to the G-SET framework, you have a multi-factor, whether this is the other systemically important institutions or the domestics systemically important banks, you've got this multi factor framework. And in Congress there's been, I think, Luetkemeyer Bill. So I was wondering for all three of you, what your thoughts are. Or instead of just raising the threshold to 250 or indexing it to something, having a different approach that uses sort of the multi factor approach?

MR. BERNSTEIN: Just on the general question of the multi factor approach, clearly the type of activities that the bank is involved in or any financial institution is involved in, have a material impact on whether it needs special attention. So it seems to me that simply looking at size is something that may not capture all of the necessary variables. So in that sense, you know, just as a logical matter, there was some sense to that.

MR. KLEIN: So at the risk of sounding schizophrenic, I don't think a number alone is valuable. But my concern with the Luetkemeyer approach is there is no number. And so wherever you've seen this debate about no number in non-bank SIFI designations. Which in my mind have been somewhat lacking as a framework, right?

When people say you shouldn't just look at size, the very next term everybody uses is "Interconnectedness." There's a whole host of other factors you could pick, but it's always interconnectedness is the very next one. So let's ask an intellectual question. What is the most interconnected financial institution in America that is not part of the United States Government?

The answer, as Alan noted, is the Federal Home Loan Banks. Legally they are jointly and severally liable of the entire United States essentially financial system. You cannot legally be more interconnected that the Home Loan Bank system. It is impossible. They were trillion dollars of advances in their peak in 2007. They disproportionately funded heavy sub-prime mortgage originators. Take a look at the largest sets of advances of Home Loan Banks in ’05, ’06. They legally cannot be resolved because their stock must be redeemed at par. Getting to kind of Jeremiah’s point about structural problems where things are required to be at a value even if their economic value has gone down.

Were they ever designated as systemically important financial institutions? No. So in my mind, if you had a case, that kind of compelling in a non-factor thing that never made it there, why should we be more relaxed about allowing no guideposts?

If you look at the thing that has come out, it’s actually been reported in the press it’s from 50 to 250, but that’s not actually accurate. According to the section-by-section, and I think Chairman’s Gruenberg’s wisdom is “Don’t fully believe anything until you’ve read the text.” It’s actually between 100 and 250 the Fed has the discretion to apply enhanced prudential standards. And then below 100 not, and above 250 they must. That’s how I read the section-by-section.

That gives a little bit of your discretion into all things aren’t the same. But also kind of belay some of my concern of just, you know, when anybody can decide it’s everything, somehow becomes nothing.

So we have the system we have, I think the best way to probably do it is to have a truly open rulemaking, one that’s not pre-decided by the agencies where they ask for comments but don’t really want to get comments. But what’s the right way to supervise more complex institutions. I’m personally not a big fan of statutory cliffs where you have behavior changes around $9.9 billion firms and $49.9 billion firms and, you know, you could see that happening again at 249.9. There are different ways the banking agencies try to do it, yet a

certain number of assets that are in training or markets or cross-border. I mean there are a lot of metrics that were probably better suited to focus supervisory attention than just a number and a statute.

So that would be my view.

MS. SOLOMON: I know we probably gotta wrap up, almost time, and Don has to catch a light. So thank you very much to the panelist, and thanks again to Chairman Gruenberg for coming in.

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