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The Honorable Timothy F. Geithner
U.S. Department of the Treasury
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Committee on Financial Services
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Chairman Bachus, Ranking Member Frank, and members of the Committee, thank you for inviting me to testify today on behalf of the Financial Stability Oversight Council (the "Council").

In setting up this Council, you asked us to provide in a public, annual report a comprehensive view of financial market developments and potential threats to our financial system. My testimony today will review the conclusions and recommendations made by the Council in its first annual report, which is being submitted in full alongside this testimony.

In 2011, the world economy is still healing from the devastating effects of the financial crisis. On top of those challenges, we experienced a series of additional shocks early this year, including high oil prices and the disaster in Japan. Europe's protracted economic and financial crisis has added to these pressures on global growth. And the destructive debate surrounding the debt limit this summer has damaged the confidence of American businesses and consumers.

Some of these factors have eased in recent months, as oil prices have fallen and Japan has begun to recover. But the cumulative effect of the pressures has resulted in slower growth in the United States and around the world, with lowered expectations for growth next year.

The crisis in Europe presents a significant risk to global recovery. We are working closely alongside the IMF to encourage European leaders to move more forcefully to put in place a comprehensive strategy to stabilize the situation. The critical imperative is to ensure that the governments and the financial systems under pressure have access to a more powerful financial backstop, conditioned on policy actions that credibly address the underlying causes of concern for a sustained period of time.

In the face of the situation in Europe, and the general slowdown across the world, the most important thing we can do is take strong steps to strengthen our economy at home. The most effective strategy for doing that is to enact steps now that will accelerate economic growth, tied to long term reforms to restore fiscal sustainability.

The American Jobs Act provides a substantial package of tax cuts and investment that, according to estimates by outside economists, would raise economic growth by one to two percentage points and help create one to two million new jobs. And in the President's proposal to the Joint Committee of Congress charged with reducing our long-term deficits, we outlined a comprehensive package of reforms to spending programs and the tax system that would bring our deficits down to the level where our overall debt burden starts to decline as a share of our economy.

The Council is composed of each of the agencies responsible for oversight of the financial system and the firms and markets that comprise it. In the judgment of this Council, the United States financial system is in a significantly stronger position and better able to withstand the new risks we face in the global economy.

Because of the actions we have taken to repair and reform our system:

- The weakest parts in our financial system—the entities that took the most risk—no longer exist or have been significantly restructured.

- The firms that survived are better capitalized—large banks have increased common equity by over $300 billion since the beginning of 2009. And the level of common equity to risk weighted assets across these banks is now approximately 10 percent, up from six percent at the beginning of 2009.

- Banks are funding themselves more conservatively and are maintaining much larger cushions of safe and liquid financial assets. Debt maturing in one year or less at the largest institutions, as a share of total liabilities, has declined dramatically to roughly 40 percent of the pre-crisis level.

- The major banks have reduced the size and overall risk in their balance sheets, resulting in a substantial decrease in leverage—a major source of risk—compared to pre-crisis levels.

- The "shadow banking system"—the financial firms that operate outside of a framework of oversight and prudential regulation—is much smaller, with assets at roughly half the level of 2007.

These improvements are very significant. Together they represent more progress on the path to a more stable and resilient financial system than has been achieved in the other major economies.

The European financial crisis has placed significant pressure on its financial institutions and slowed growth significantly in Europe and around the world. U.S. financial institutions, including our major banks and money market funds have substantially reduced their exposure to the economies of Europe that are under the most pressure. Our direct financial exposure to those governments and their financial institutions is quite small, but Europe is so large and so closely integrated with the U.S. and world economies that a severe crisis in Europe could cause significant damage by undermining confidence and weakening demand.

This makes it even more important that Congress act to strengthen growth now and put our fiscal position on a more sustainable path.

Economic and financial developments since the release of the Council's report reinforce the importance of its recommendations. Here are those recommendations in summary form.

First, the Council emphasizes the importance of further actions to strengthen the financial position of the core of the U.S. financial system, particularly the largest institutions. We want the largest institutions to manage their businesses so that they have the ability to weather more challenging future environments without government assistance in crisis.

Toward this objective, regulators will gradually phase in, over a period of several years, the much tougher standards for capital and liquidity we have negotiated with the other major financial systems around the world.

These efforts focused on the largest banks are complemented by recommendations designed to make other key market participants more resilient to future challenges to growth and financial stability.

And the report draws attention to new market structures and financial products, such as exchange traded funds and structured notes, where we have seen very rapid growth and innovation.
A robust financial system should encourage and foster innovation, but not at the expense of overall financial stability.

Second, the Council recommends reforms to strengthen a number of key funding markets in the United States, markets that were a critical source of vulnerability in the crisis. The most important of these recommendations are directed at the tri-party repo markets and the money market funds. The essence of these recommendations is to make the tri-party repo markets and money funds themselves less vulnerable to the classic dynamic in which an abrupt rush for the exits forces a damaging spiral of asset sales, deleveraging and broader contagion. Substantial progress has been made toward this objective, but we have more work to do.

Third, the Council recommends reforms to the housing finance system. In this context, it recommends action to establish national standards for the mortgage servicing market, in order to better align incentives and help reestablish confidence in the integrity of the housing market. And the Council emphasizes the importance of broader reforms to help return private capital to the housing market, strengthen mortgage underwriting, and reduce over time the role of the government in the housing markets. As we proceed with these reforms, we want to make sure that we are encouraging, not undermining, the prospects for broader recovery in the housing market.

Fourth, the Council emphasizes the importance of closer cooperation and coordination in the implementation of financial reforms, both here in the United States and around the world. This is crucial because if we allow large gaps to emerge as we did in the years before the crisis, risk will migrate to those gaps, leaving the system as a whole more vulnerable to another crisis.

Differences in the design of standards in particular areas create opportunities for firms and investors to take advantage of those weaker standards. As we act to contain risk in the United States, we want to minimize the chances that it simply moves to other markets around the world, ultimately endangering our own system. The most important challenges we face in building a level playing field lie in the design of new capital standards and liquidity rules for the largest institutions and reforms to the derivatives markets.

The Council's recommendations are designed to address the challenges we see today, but also those inherent in a dynamic, innovative financial system. We cannot predict the precise threats that may face the financial system. The best way to prepare for this uncertainty is to continue to build the shock absorbers and safeguards that improve the resilience of the financial system. We need to recognize that policy and regulation will often be behind the curve of financial innovation. The best course is to plan for constant change and the potential for instability and to recognize that the threats will come in ways we cannot predict or fully understand.

Although our financial system today is much stronger than it was before the crisis, our work is not complete. To preserve the gains we have achieved and to reduce both the risk of and the damage from future crises, we must continue to implement financial reform, pass comprehensive housing finance reform, and move forward with the other recommendations of the Council.

We will do this with a balanced approach, weighing the benefits of regulation against the costs of excessive restraint. We need to move at a pace that fully recognizes the fragility of the global economic recovery, phasing in reforms over time so that we limit the risks to growth.

As we move forward, I encourage Congress to strengthen our capacity to continue repairing our financial system and to make sure that investors and consumers are afforded better protections against abuses and unfair practices. This means making sure that qualified people are in place to run the financial agencies. And it requires that Congress provide sufficient funding for enforcement agencies to do their jobs in today's complicated and challenging financial environment. If we leave the agencies responsible for enforcement underfinanced, then we will leave the American consumers, investors, and businesses that depend on our financial system more vulnerable.

In closing, I want to thank the other members of the Financial Stability Oversight Council, as well as the Council's staff, for the work they have done over the past year and their efforts to produce this annual report.

We look forward to working with this Committee, and with Congress as a whole, to build on the substantial progress we have made to create a stronger financial system.