S. HRG. 111–8

MODERNIZING AMERICA'S FINANCIAL REGULATORY STRUCTURE

HEARING

BEFORE THE

CONGRESSIONAL OVERSIGHT PANEL

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

JANUARY 14, 2009

Printed for the use of the Congressional Oversight Panel

MODERNIZING AMERICA'S FINANCIAL REGULATORY STRUCTURE

S. Hrg. 111–8

MODERNIZING AMERICA'S FINANCIAL REGULATORY STRUCTURE

HEARING

BEFORE THE

CONGRESSIONAL OVERSIGHT PANEL

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

JANUARY 14, 2009

Printed for the use of the Congressional Oversight Panel

U.S. GOVERNMENT PRINTING OFFICE

47–928 WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

CONGRESSIONAL OVERSIGHT PANEL

PANEL MEMBERS

ELIZABETH WARREN, *Chair*

SEN. JOHN SUNUNU

REP. JEB HENSARLING

RICHARD H. NEIMAN

DAMON SILVERS

CONTENTS

WITNESS LIST

REGULATORY REFORM HEARING

WEDNESDAY, JANUARY 14, 2009

U.S. CONGRESS,
CONGRESSIONAL OVERSIGHT PANEL,
Washington, DC.

The panel met, pursuant to notice, at 11:40 a.m. in Room SR–253, Russell Senate Office Building, Professor Elizabeth Warren presiding.

OPENING STATEMENT OF PROFESSOR ELIZABETH WARREN, CHAIR OF THE CONGRESSIONAL OVERSIGHT PANEL

Professor WARREN. The Congressional Oversight Panel has two duties. Our first, to oversee the expenditure of funds from the so-called "Troubled Asset Relief Program," requires us to issue monthly reports discussing the management of the $350 billion allocated so far by the Congress to the Treasury Department.

But it is the second function that draws us here today. Congress has asked that we deliver in very short order a report "analyzing the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers and providing recommendations for improvement, including, among others, whether there are any gaps in existing consumer protection."

We are grateful to have the assistance of so many thoughtful experts in this task.

The last time America faced a financial crisis of greater magnitude was in the 1930s. The policymakers who steered the country out of that dark hour put in place a regulatory architecture that served America for more than half a century. Had those leaders chosen a different path, a path without deposit insurance, without banking regulation, without a Securities and Exchange Commission, we would be a very different country today.

Today's policymakers stand at a similarly important point of inflection. The path they take from here will shape this country deep into the 21st Century. What we get right may not only save an America that is in danger of losing its economic security, it may also shape a new America that is stronger than ever. But what we get wrong may batter a weakened country, leaving it staggered and vulnerable. We will pay for errors we make here as will our children and our children's children.

Alan Greenspan now tells us the very premise of deregulation was misplaced and that he was surprised by this crisis. George Bush tells us that we must abandon capitalism in order to save it.

These leaders make it clear that the old orthodoxies are dead. What they do not make clear is how we go forward.

The questions we ask today are ultimately very simple. What went wrong, and how do we make very sure that these problems are not repeated in the future?

I appreciate that any problem may have multiple causes, and I fully understand that financial markets have more twists and turns than the back streets of Boston, but underlying the complex maneuvering in the current economic system are some basic truths about how financial institutions failed the American people and how those whose jobs it was to monitor and to regulate those institutions also failed us.

Now, with the country in crisis, the American people must not only bear the broken promises of Wall Street and the regulators who were supposed to hold deception and risk in check, they must also bear the double-burden of spending their tax dollars to bail out those who failed.

We are not here to discuss regulation as a political issue or regulation as an academic exercise. Regulation is a means to an end, not an end in itself. More importantly, it is a means not just to help the financial system as a whole but those who give that financial system purpose, American businesses and American families. The stakes on financial regulation have not been higher during our lifetimes.

Today, we will hear from a variety of experts as they give their perspectives on what went wrong and what can be done to ensure future stability. We have purposely solicited witnesses from a wide range of ideological perspectives and with a broad diversity of prescriptions for our future.

On our first panel, we will be joined by Gene Dodaro, the Acting Comptroller General of the Government Accountability Office. Mr. Dodaro will discuss a recent GAO Report on Regulatory Reform. He will be accompanied by Richard Hillman and Orice Williams, also with the GAO.

Our second panel I will introduce just before they start.

With that, I will yield to my colleague, Congressman Hensarling, for his opening statement.

STATEMENT OF HON. JEB HENSARLING, U.S. REPRESENTATIVE FROM THE STATE OF TEXAS AND MEMBER OF THE CONGRESSIONAL OVERSIGHT PANEL

Representative HENSARLING. Thank you, Madam Chair. We certainly look forward to the testimony of the witnesses. I'm certainly impressed again by the variety and expertise that will be brought to this panel.

In a city where it's difficult to find consensus, I think there is at least consensus around the idea that we need regulatory reform within our financial markets, but more regulation simply for regulation's sake will probably do more harm than good.

Many believe that—look for opportunities to use the present recession to essentially bootstrap a certain ideological agenda and to thrust that into the body politic. The battle cry is deregulation has caused this recession, only regulation will prevent future recessions.

First, I observe in my own estimation, we haven't had significant deregulation in decades. There have been reforms. There has been some modernization.

Second, I don't view this as a matter of deregulation versus regulation. Frankly, I think the far more important dichotomy is that between smart regulation and dumb regulation. I think smart regulation will help markets become more competitive. I think smart regulation will effectively police markets for fraud and misrepresentation.

I think smart regulation will empower consumers with effective disclosure, perhaps in contrast to voluminous disclosure, so that those consumers can make rational decisions. I think smart regulation will help reduce systemic risk.

On the other hand, I think dumb regulation will hamper competitive markets. I think it will stifle innovation that has helped put people into homes that otherwise perhaps would never be able to afford them. I think dumb regulation creates moral hazard, and I think we are unfortunately reaping what has been sown previously as far as dumb regulation is concerned with respect to moral hazard.

I think dumb regulation will remove and minimize personal responsibility from the economic equation to the detriment of our society. I think it needlessly would restrict personal freedom. I think dumb regulation is pro-cyclical and ultimately will pass on greater costs than benefits to our consumers in our nation.

Now, I have served in Congress. I've had the privilege of serving in Congress for the last six years. I spent the previous 10 years in private business. I have not observed that regulators are inherently more intelligent than regulatees nor have I concluded that regulatory institutions are any more infallible than private businesses and private institutions.

For example, if regulators are so wise, why did IndyMac fail? Why did we have the S&L debacle of the early to mid '80s? And in fact, there appears to be now general agreement among most economic historians that the Great Depression would have been a garden variety recession had it not been for grievous public policy errors in monetary policy, trade policy, and tax policy.

And so, additionally, I would observe that those who are proposing even more restrictive regulatory proposals as a cure to our woes, that many of the proposals that are being proffered already appear in the EU, among certain other industrialized nations, and yet they have not seemed to be insulated from the economic woes that befall our nation at this time.

To state the obvious, families are struggling in this economy. They need help. They need public policies that help preserve and grow their job opportunities. They need public policies that increase their take-home pay so they can meet their mortgage payments, their health care payments, and they need public policies that don't send the bill for all of this to their children and their grandchildren.

And finally, to the business of this panel, they need reform and modernized capital markets regulation. In that regard, I think the recommendations that we make to Congress will be very, very important. We must examine all the but-for causes, all the contributing causes to our economic turmoil and make sure that we make smart regulatory recommendations and be careful that, as we make these recommendations, that we are not simply solving the problem of this recession and laying the groundwork for an even greater recession to befall us in the years to come.

We all must be mindful of the Hippocratic Oath, first do no harm. It is my hope that our panel will do more good than harm with our regulatory recommendations.

With that, Madam Chair, again I thank you and I yield back the balance of my time.

Professor WARREN. Thank you, Congressman. The Chair recognizes Damon Silvers.

STATEMENT OF DAMON SILVERS, MEMBER OF THE CONGRESSIONAL OVERSIGHT PANEL

Mr. SILVERS. Yes. Good morning, and thank you, Chairman Warren.

Today, the Congressional Oversight Panel takes up its mandate to examine reforms that will strengthen our financial regulatory system and protect our nation from a repeat of the current financial crisis or a worse version of it.

I am profoundly grateful to the witnesses and the staff for bringing this hearing together on such short notice and in such an effective manner.

Several themes have emerged already in relation to needed reform, themes involving both regulatory substance and regulatory structure.

We also face a number of complex dilemmas, again involving both regulatory substance and regulatory structure.

I am certain today's extremely distinguished panels will help us formulate specific policy responses to weaknesses in our regulatory system and help us think through those more difficult conceptual problems that have been brought into focus by the financial crisis.

As we begin this hearing, let us keep in mind that financial markets are not ends in themselves nor do they exist to make market intermediaries wealthy. The purpose of financial markets is to facilitate the transformation of savings into profitable investment, to allocate our society's resources to productive purposes.

When regulatory systems fail, when financial markets and financial institutions become manufacturers of bubbles and Ponzi schemes of one kind or another, then our wealth as a society is dissipated and our society's needs go unmet.

With that in mind, I think we have already learned some lessons of the financial crisis. First, we as a nation cannot continue a Swiss cheese regulatory system. As President-elect Obama has said, and I quote, "We must regulate financial institutions based on what they do, not what they are. We must bring the shadow markets and shadow institutions into the light of disclosure and accountability."

Second, we must abandon the idea that sophisticated parties should be allowed to act in financial markets without any regulatory oversight. Big sophisticated and yet reckless financial actors have done a lot of damage to our financial system and to our economy.

Third, we need strong independent regulators, not weak compromised regulators. Some of this comes down to leadership which cannot be legislated, but some of it comes down to structure and mission. If we say we don't want "enforcement-oriented regulators," we should not be surprised when our laws go unenforced.

Fourth, effective financial regulation is made up of several distinct objectives. We need a regulatory system that facilitates transparency and accountability, that polices safety and soundness when there are public guarantees or systemic risk in play and that protects the vast majority of us who are neither expert nor powerful when we seek financial services.

We should learn the lesson of having asked the Federal Reserve, a self-regulatory body, to both protect homeowners in the mortgage market and ensure the safety and soundness of bank holding companies. We ended up achieving neither goal. Not every regulator can serve every regulatory function and some functions are in tension with each other.

And now for some challenges. What do we do about financial institutions that are both commercial and investment banks and currently receive implicit federal guarantees covering their entire businesses? Do we break them up? How do we address this? Do we try to withdraw the implicit guarantee? Do we regulate their entire businesses, like they were all just commercial banks? Do we charge risk-based premiums for each line of business? This is a genuine dilemma. The answer is not obvious.

Some have suggested that somewhat technical developments in finance, such as the rise of mark to market accounting, the widespread availability of short selling, and the prevalence of multilayered securitizations, significantly contributed to the financial crisis.

What each of these developments has in common is that they appear to make financial institutions more responsive to and integrated with financial markets. Is this a good thing or a bad thing? To what extent should these developments be limited or reversed? Can they be reversed even if we wanted to?

Finally, we have globalized financial markets. How do we set a global regulatory floor? The answer to that question again is not obvious.

I am looking forward to an in-depth examination of these and other issues today.

Thank you.

Professor WARREN. Thank you, Mr. Silvers. Senator Sununu.

STATEMENT OF HON. JOHN SUNUNU, FORMER U.S. SENATOR FROM THE STATE OF NEW HAMPSHIRE AND MEMBER OF THE CONGRESSIONAL OVERSIGHT PANEL

Senator SUNUNU. Thank you very much, Madam Chair, and good morning to all of our witnesses.

There are a few goals that I think ought to come out of a hearing like this and I appreciate those that are attending today for being here. It's very important because, first and foremost, whether you're a panelist or a member of Congress, you can't possibly be an expert in all these areas.

I hope that our witnesses today will help us understand how we got to this point, help us understand the inherent weaknesses in the structure of our regulatory system, but equally important, understand the weaknesses in the operation of that system: how you can have a good system of regulation, good rules and laws in place, good organizational structure. But let's face it, regulators themselves can fail to identify trends, can fail to see problems, can fail to exercise due diligence. So structure is important but the operation of those systems are equally important. Finally, we need to consider human behavior, understand how market behavior helps drive or create some of the problems we've seen both in the real estate markets, the securities market, and in the oversight of those markets.

Second, I think our panelists today can really help us understand the complexity of our financial services regulatory system and I don't think this can be over-emphasized.

Our system, by and large, was created incrementally. Many, many different pieces of legislation, passed not over a few years, but over many decades. Many of the elements of our financial services regulatory system date to the 1930s and 1940s, and that means, by definition, that they were not designed expressly for the modern financial services system that we see today.

I think we need to look hard and carefully at that complexity because complexity can create gaps, and complexity can create duplication. Either can cause significant unintended consequences. As a further result of the complexity, I think it's fair to say that the financial services regulatory system is not well understood by many members of Congress, especially those that don't sit on the committees that oversee or have responsibility for this regulatory system. We are in a position, given our structure of government, that those members of Congress will be responsible for acting on the recommendations of this panel, and acting on the various recommendations that are put forward in public by our panelists today. We need to help them to understand that complexity.

As an example of the incremental way in which our regulatory structure is created, we don't have to go back any farther than the well-publicized financial scandals of 2000, 2001, 2002, and the response to that which was Sarbanes-Oxley. That was a well-intentioned piece of legislation. There are many elements in that legislation that are probably of value, but it is clear that that attempt at regulatory reform, driven by contemporary events, did little or nothing to forestall the crisis that we're dealing with today. So a process of incremental revision has not served us very well in the United States.

Finally, I'd encourage our panelists to be specific. The legislative process is about as far removed from academia as you can get. That doesn't mean we shouldn't be informed by both theory and ideas that come from an academic source, but we have to deal with the hand that we've been dealt which is the current regulatory structure. We need to work from that structure to one that works better for all the shareholders and participants.

So we need to be practical, we need to be specific, and, of course, we need to work in a very diligent way. These are issues that the panel is going to be addressing in the coming weeks, and these are issues that the Congress will be dealing with extensively in the months ahead.

Thank you very much.

Professor WARREN. Thank you, Senator. Mr. Neiman.

STATEMENT OF MR. RICHARD NEIMAN, MEMBER OF THE CONGRESSIONAL OVERSIGHT PANEL

Mr. NEIMAN. Good morning. I thank all the witnesses for being here today.

We are at an exceptional moment in our nation's history where the financial system is at greater risk than any point in the past hundred years. The strain has revealed significant underlying weaknesses in the existing supervisory system not only in the U.S. but worldwide.

While regulatory reform is an ongoing process, I believe that there are four key areas to include in any immediate action plan. I base this on a broad range of experience over my last 30 years, having started as an attorney at the OCC, as an attorney within financial institutions, as an executive as well as a regulatory consultant and compliance consultant, and now, for the last two years as a state bank supervisor.

I welcome your views on the wide range of issues, but I am especially interested in your recommendations in four key areas.

First, on consumer protection. In fulfilling our consumer protection responsibilities, our top priority must be to address the subprime mortgage defaults and foreclosures that triggered the current market turmoil and harmed so many homeowners, neighborhoods and economies.

Second, the role of the states. As the business of banking institutions has become more national in scope, they often complain that it is burdensome to comply with consumer protection regulations in 50 different states. Federal regulators of banks, thrifts and credit unions, therefore, have preempted the consumer protection rules of the states who sounded the early warning on predatory lending. Preemption issues remain a major concern.

Third, there are gaps in regulatory coverage, both structurally at the agency level but also institutionally at the institution level as well as the product level.

And fourth, systemic risk. I believe that it is crucial at this stage that we develop a better mechanism for controlling systemic risk across the diverse players and financial services industry. We want to encourage innovation that has long given the U.S. an economy that is second to none, but we need to strengthen our regulatory tools by making sure that all market participants whose failure would pose risks to the broader financial system are subject to supervision.

These issues of regulatory reform affect us all because instability in the financial markets affects the broader economy. As we have seen in the past few months, financial market instability jeopardizes retirement savings, access to consumer credit and student loans and the financing of businesses large and small, the revenues of state and local governments, and the fiscal condition of the nation.

Now, as much as many of us agree that this is the right time in our nation's history to address regulatory reform, we must also acknowledge that there is no perfect regulatory model. We only have to look to the many nations in the world that adopt different regulatory schemes and recognize that none of those jurisdictions were spared a crisis or problem.

Therefore, in addition to restructuring our regulatory architecture, we need to have more effective regulations and more effective supervision. I believe that the power of this panel really is that we bring together a broad expertise with different backgrounds across different ideological viewpoints as well as political parties.

The Panel's power is also in being able to call out experts like yourselves in a broad input, for external input from academics, from industry, and from the public. But I think the greatest power of this panel is our diversity and to the extent that we can reach consensus on these important issues of the day. I think that will be very, very meaningful to Congress.

So again, I thank you all for being here today and I look forward to your testimony and questions.

Professor WARREN. Thank you, Mr. Neiman. We begin then with Mr. Dodaro.

I want to thank you again, Acting Comptroller, for being here and for coming to talk with us about your Regulatory Reform Report, and thank you again, Ms. Williams and Mr. Hillman, for being with us.

Mr. Dodaro, I'd like to start with your opening statement. Your entire statement will be in the record, of course. So if you would hold your oral remarks to five minutes, we'd be grateful.

STATEMENT OF MR. GENE DODARO, ACTING COMPTROLLER GENERAL OF THE UNITED STATES, GOVERNMENT ACCOUNTING OFFICE

Mr. DODARO. Good morning, Chair Warren, Members of the Congressional Oversight Panel. We are very pleased to be here today to assist your deliberations on the financial regulatory system.

As you mentioned, we issued a report last week. In that report, we traced the evolution of the financial regulatory system over the last 150 years to lay out and make sure everybody understood the incremental nature, as Mr. Sununu mentioned in his opening comments to that system.

We also outlined developments in the financial markets and institutions that have challenged that regulatory system in the past several decades and we lay forth for your consideration, I think it's very relevant to your deliberations, a framework for crafting and evaluating proposals to modernize the financial regulatory system structure going forward.

Our basic conclusion was that the current financial regulatory structure is outdated, fragmented, and not well suited to the 21st Century challenges. There are many issues that we point to in our report as to the basis for our conclusion there. I'll mention three this morning.

First, regulators have struggled and often failed to mitigate the systemic risk of large interconnected financial conglomerates or to effectively ensure that they manage adequately their own risk.

Second, there have been the emergence of several institutions and entities that are less regulated and have posed challenges to the system. These include non-bank mortgage lenders, hedge funds, and credit agencies.

Lastly, there have been an array of products put forth on the market that are very complex and have challenged both consumers and investors and the regulators going forward. Here, I would refer to the credit default swaps, collateralized debt obligations, and various mortgage products that have been put forward as well as over-the-counter derivatives, all of which have been less regulated than many aspects of the commercial banking sector.

Now, moving forward and trying to address these vulnerabilities is a complex task that needs to be deliberated on and taken with care to make sure there aren't unintended consequences of moving forward as well as preserving the inherent benefits of our current financial regulatory system, including the ability to foster capital formation and economic growth over a period of time. So there needs to be a balance and here we need to strive as a nation to achieve that balance going forward.

To assist in this deliberation, we've put forth a framework for consideration so that it can be looked at as a system and not just to make piecemeal changes to it. We list nine characteristics that need to be considered. I'll mention a few critical ones here.

First, there needs to be clear, explicit goals for the regulatory system set in statute to provide consistent guidance over time. Reform also needs to be comprehensive. It needs to address some of these regulatory gaps, both in institutions and products, going forward.

Oversight of systemic-wide issues is another characteristic. No one regulator right now is charged with looking at risk across the entire system, to monitor it, to provide alerts, or to deal with it in advance going forward. That's an issue that we believe needs attention.

The system needs to be flexible and adaptable. In this case, you need to make sure that innovation is still permitted while managing risk going forward, so that we maintain the benefits of innovation of the system. It needs to be efficient. We need to look at the overlapping nature of some of the regulatory organizations that have been put in place in time and make the system more streamlined and efficient going forward.

We need to look at consumer protections again. Disclosures are very important as well as financial literacy issues and other key factors that should be part of the overall approach here going forward. The independence of the regulators is another very important characteristic to make sure that they're funded, they're resourced, and they have proper statutory independence to be able to do what's necessary, and we need to protect the taxpayers. We need to deal with moral hazards approaches and provide safeguards in place so that the losses, if they occur, are borne by the industry and not by the taxpayers going forward.

We would be happy to answer your questions at this time, and again thank you for inviting us to be here.

[The prepared statement of Mr. Dodaro follows:]

United States Government Accountability Office

GAO

Testimony
Before the Congressional Oversight Panel

For Release on Delivery
Expected at 9:00 a.m. EST
Wednesday, January 14, 2009

FINANCIAL REGULATION

A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System

Statement of Gene L. Dodaro
Acting Comptroller General of the United States

GAO
Accountability * Integrity * Reliability

GAO-09-310T

Chair Warren and Members of the Panel:

I am pleased to be here today to discuss our January 8, 2009, report that provides a framework for modernizing the outdated U.S. financial regulatory system.[1] We prepared this work under the authority of the Comptroller General to help policymakers weigh various regulatory reform proposals and consider ways in which the current regulatory system could be made more effective and efficient. My statement today is based on our report, which (1) describes how regulation has evolved in banking, securities, thrifts, credit unions, futures, insurance, secondary mortgage markets and other important areas; (2) describes several key changes in financial markets and products in recent decades that have highlighted significant limitations and gaps in the existing regulatory system; and (3) presents an evaluation framework that can be used by Congress and others to shape potential regulatory reform efforts. To do this work, we synthesized existing GAO work and other studies and met with representatives of financial regulatory agencies, industry associations, consumer advocacy organizations, and others. The work upon which the report is based was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This work was conducted between April 2008 and December 2008.

The report was enhanced by input from representatives of 29 agencies and other organizations, including federal and state financial regulatory agencies, consumer advocacy groups, and financial service industry trade associations, who reviewed and commented on a draft of the report prior to its release. A list of organizations that reviewed the draft report is included at the end of my statement. In general, reviewers commented that the report represented an important and thorough review of the issues related to regulatory reform.

[1] GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO-09-216 (Washington, D.C.: Jan. 8, 2009).

Summary

The current U.S. financial regulatory system has relied on a fragmented and complex arrangement of federal and state regulators—put into place over the past 150 years—that has not kept pace with major developments in financial markets and products in recent decades. Today, almost a dozen federal regulatory agencies, numerous self-regulatory organizations, and hundreds of state financial regulatory agencies share responsibility for overseeing the financial services industry. As the nation finds itself in the midst of one of the worst financial crises ever, it has become apparent that the regulatory system is ill-suited to meet the nation's needs in the 21st century.

Several key changes in financial markets and products in recent decades have highlighted significant limitations and gaps in the existing regulatory system.

- First, regulators have struggled, and often failed, to mitigate the systemic risks posed by large and interconnected financial conglomerates and to ensure they adequately manage their risks.
- Second, regulators have had to address problems in financial markets resulting from the activities of large and sometimes less-regulated market participants—such as nonbank mortgage lenders, hedge funds, and credit rating agencies—some of which play significant roles in today's financial markets.
- Third, the increasing prevalence of new and more complex investment products has challenged regulators and investors, and consumers have faced difficulty understanding new and increasingly complex retail mortgage and credit products.
- Fourth, standard setters for accounting and financial regulators have faced growing challenges in ensuring that accounting and audit standards appropriately respond to financial market developments, and in addressing challenges arising from the global convergence of accounting and auditing standards.
- Finally, as financial markets have become increasingly global, the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

These significant developments have outpaced a fragmented and outdated regulatory structure, and, as a result, significant reforms to the U.S. regulatory system are critically and urgently needed. The current system has significant weaknesses that, if not addressed, will continue to expose

the nation's financial system to serious risks. Our report offers a framework for crafting and evaluating regulatory reform proposals consisting of nine characteristics that should be reflected in any new regulatory system. By applying the elements of the framework, the relative strengths and weaknesses of any reform proposal should be better revealed, and policymakers should be able to focus on identifying trade-offs and balancing competing goals. Similarly, the framework could be used to craft proposals, or to identify aspects to be added to existing proposals to make them more effective and appropriate for addressing the limitations of the current system.

Table 1: Framework for Crafting and Evaluating Regulatory Reform Proposals

Characteristic	Description
✓ Clearly defined regulatory goals	Goals should be clearly articulated and relevant, so that regulators can effectively carry out their missions and be held accountable. Key issues include considering the benefits of re-examining the goals of financial regulation to gain needed consensus and making explicit a set of updated comprehensive and cohesive goals that reflect today's environment.
✓ Appropriately comprehensive	Financial regulations should cover all activities that pose risks or are otherwise important to meeting regulatory goals and should ensure that appropriate determinations are made about how extensive such regulations should be, considering that some activities may require less regulation than others. Key issues include identifying risk-based criteria, such as a product's or institution's potential to create systemic problems, for determining the appropriate level of oversight for financial activities and institutions, including closing gaps that contributed to the current crisis.
✓ Systemwide focus	Mechanisms should be included for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk. Given that no regulator is currently tasked with this, key issues include determining how to effectively monitor market developments to identify potential risks; the degree, if any, to which regulatory intervention might be required; and who should hold such responsibilities.
✓ Flexible and adaptable	A regulatory system that is flexible and forward looking allows regulators to readily adapt to market innovations and changes. Key issues include identifying and acting on emerging risks in a timely way without hindering innovation.
✓ Efficient and effective	Effective and efficient oversight should be developed, including eliminating overlapping federal regulatory missions where appropriate, and minimizing regulatory burden without sacrificing effective oversight. Any changes to the system should be continually focused on improving the effectiveness of the financial regulatory system. Key issues include determining opportunities for consolidation given the large number of overlapping participants now, identifying the appropriate role of states and self-regulation, and ensuring a smooth transition to any new system.
✓ Consistent consumer and investor protection	Consumer and investor protection should be included as part of the regulatory mission to ensure that market participants receive consistent, useful information, as well as legal protections for similar financial products and services, including disclosures, sales practice standards, and suitability requirements. Key issues include determining what amount, if any, of consolidation of responsibility may be necessary to streamline consumer protection activities across the financial services industry.
✓ Regulators provided with independence, prominence, authority, and accountability	Regulators should have independence from inappropriate influence, as well as prominence and authority to carry out and enforce statutory missions, and be clearly accountable for meeting regulatory goals. With regulators with varying levels of prominence and funding schemes now, key issues include how to appropriately structure and fund agencies to ensure that each one's structure sufficiently achieves these characteristics.
✓ Consistent financial oversight	Similar institutions, products, risks, and services should be subject to consistent regulation, oversight, and transparency, which should help minimize negative competitive outcomes while harmonizing oversight, both within the United States and internationally. Key issues include identifying activities that pose similar risks, and streamlining regulatory activities to achieve consistency.
✓ Minimal taxpayer exposure	A regulatory system should foster financial markets that are resilient enough to absorb failures and thereby limit the need for federal intervention and limit taxpayers' exposure to financial risk. Key issues include identifying safeguards to prevent systemic crises and minimizing moral hazard.

Source: GAO.

As the administration and Congress continue to take actions to address the immediate financial crisis, determining how to create a regulatory system that reflects new market realities is a key step to reducing the likelihood that the United States will experience another financial crisis similar to the current one.

Today's Financial Regulatory System Was Built over the Course of More Than a Century, Largely in Response to Crises or Market Developments

As a result of 150 years of changes in financial regulation in the United States, the regulatory system has become complex and fragmented. Today, responsibilities for overseeing the financial services industry are shared among almost a dozen federal banking, securities, futures, and other regulatory agencies, numerous self-regulatory organizations, and hundreds of state financial regulatory agencies. In particular, five federal agencies—including the Federal Deposit Insurance Corporation, the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration—and multiple state agencies oversee depository institutions. Securities activities are overseen by the Securities and Exchange Commission and state government entities, as well as by private sector organizations performing self-regulatory functions. Futures trading is overseen by the Commodity Futures Trading Commission and also by industry self-regulatory organizations. Insurance activities are primarily regulated at the state level with little federal involvement. Other federal regulators also play important roles in the financial regulatory system, such as the Public Company Accounting Oversight Board, which oversees the activities of public accounting firms, and the Federal Trade Commission, which acts as the primary federal agency responsible for enforcing compliance with federal consumer protection laws for financial institutions, such as finance companies, which are not overseen by another financial regulator.

Much of this structure has developed as the result of statutory and regulatory changes that were often implemented in response to financial crises or significant developments in the financial services sector. For example, the Federal Reserve System was created in 1913 in response to financial panics and instability around the turn of the century, and much of the remaining structure for bank and securities regulation was created as the result of the Great Depression turmoil of the 1920s and 1930s. Changes in the types of financial activities permitted for depository institutions and their affiliates have also shaped the financial regulatory system over time. For example, under the Glass-Steagall provisions of the Banking Act of 1933, financial institutions were prohibited from simultaneously offering commercial and investment banking services, but with the passage of the Gramm-Leach-Bliley Act of 1999 (GLBA), Congress permitted financial institutions to fully engage in both types of activities.

Changes in Financial Institutions and Their Products Have Significantly Challenged the U.S. Financial Regulatory System

Several key developments in financial markets and products in the past few decades have significantly challenged the existing financial regulatory structure. (See fig. 1.) First, the last 30 years have seen waves of mergers among financial institutions within and across sectors, such that the United States, while still having large numbers of financial institutions, also has several very large globally active financial conglomerates that engage in a wide range of activities that have become increasingly interconnected. Regulators have struggled, and often failed, to mitigate the systemic risks posed by these conglomerates, and to ensure they adequately manage their risks. The portion of firms that conduct activities across the financial sectors of banking, securities, and insurance increased significantly in recent years, but none of the regulators is tasked with assessing the risks posed across the entire financial system.

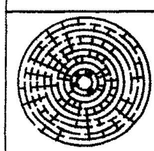
A second dramatic development in U.S. financial markets in recent decades has been the increasingly critical roles played by less-regulated entities. In the past, consumers of financial products generally dealt with entities such as banks, broker-dealers, and insurance companies that were regulated by a federal or state regulator. However, in the last few decades, various entities—nonbank lenders, hedge funds, credit rating agencies, and special-purpose investment entities—that are not always subject to full regulation by such authorities have become important participants in our financial services markets. These unregulated or less regulated entities can sometimes provide substantial benefits by supplying information or allowing financial institutions to better meet demands of consumers, investors or shareholders, but pose challenges to regulators that do not fully or cannot oversee their activities. For example, significant participation in the subprime mortgage market by generally less-regulated nonbank lenders contributed to a dramatic loosening in underwriting standards leading up to the current financial crisis.

A third development that has revealed limitations in the current regulatory structure has been the proliferation of more complex financial products. In particular, the increasing prevalence of new and more complex investment products has challenged regulators and investors, and consumers have faced difficulty understanding new and increasingly complex retail mortgage and credit products. Regulators failed to adequately oversee the sale of mortgage products that posed risks to consumers and the stability of the financial system.

Fourth, standard setters for accounting and financial regulators have faced growing challenges in ensuring that accounting and audit standards appropriately respond to financial market developments, and in addressing challenges arising from the global convergence of accounting and auditing standards.

Finally, with the increasingly global aspects of financial markets, the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators. For example, the current system has complicated the ability of financial regulators to convey a single U.S. position in international discussions, such the Basel Accords process for developing international capital standards, and international officials have also indicated that the lack of a single point of contact on, for example, insurance issues has complicated regulatory decision making.

Figure 1: Key Developments and Resulting Challenges That Have Hindered the Effectiveness of the Financial Regulatory System

Developments in financial markets and products		Examples of how developments have challenged the regulatory system
	**Emergence of large, complex, globally active, interconnected financial conglomerates**	Regulators sometimes lack sufficient authority, tools, or capabilities to oversee and mitigate risks.
		Identifying, preventing, mitigating, and resolving systemic crises has become more difficult.
	**Less-regulated entities have come to play increasingly critical roles in financial system**	Nonbank lenders and a new private-label securitization market played significant roles in subprime mortgage crisis that led to broader market turmoil.
		Activities of hedge funds have posed systemic risks.
		Overreliance on credit ratings of mortgage-backed products contributed to the recent turmoil in financial markets.
		Financial institutions' use of off-balance sheet entities led to ineffective risk disclosure and exacerbated recent market instability.
	**New and complex products that pose challenges to financial stability and investor and consumer understanding of risks.**	Complex structured finance products have made it difficult for institutions and their regulators to manage associated risks.
		Growth in complex and less-regulated over-the-counter derivatives markets have created systemic risks and revealed market infrastructure weaknesses.
		Investors have faced difficulty understanding complex investment products, either because they failed to seek out necessary information or were misled by improper sales practices.
		Consumers have faced difficulty understanding mortgages and credit cards with new and increasingly complicated features, due in part to limitations in consumer disclosures and financial literacy efforts.
		Accounting and auditing entities have faced challenges in trying to ensure that accounting and financial reporting requirements appropriately meet the needs of investors and other financial market participants.
	**Financial markets have become increasingly global in nature, and regulators have had to coordinate their efforts internationally.**	Standard setters and regulators also face new challenges in dealing with global convergence of accounting and auditing standards.
		Fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators, such as negotiations on Basel II and certain insurance matters.

Sources: GAO (analysis); Art Explosion (images).

A Framework for Crafting and Assessing Alternatives for Reforming the U.S. Financial Regulatory System

As a result of significant market developments in recent decades that have outpaced a fragmented and outdated regulatory structure, significant reforms to the U.S. regulatory system are critically and urgently needed. The current system has important weaknesses that, if not addressed, will continue to expose the nation's financial system to serious risks. As early as 1994, we identified the need to examine the federal financial regulatory structure, including the need to address the risks from new unregulated products.[2] Since then, we have described various options for Congress to consider, each of which provides potential improvements, as well as some risks and potential costs.[3] Our report offers a framework for crafting and evaluating regulatory reform proposals; it consists of the following nine characteristics that should be reflected in any new regulatory system. By applying the elements of this framework, the relative strengths and weaknesses of any reform proposal should be better revealed, and policymakers should be able to focus on identifying trade-offs and balancing competing goals. Similarly, the framework could be used to craft proposals, or to identify aspects to be added to existing proposals to make them more effective and appropriate for addressing the limitations of the current system.

1. ***Clearly defined regulatory goals.* A regulatory system should have goals that are clearly articulated and relevant, so that regulators can effectively conduct activities to implement their missions.**

A critical first step to modernizing the regulatory system and enhancing its ability to meet the challenges of a dynamic financial services industry is to clearly define regulatory goals and objectives. In the background of our report, we identified four broad goals of financial regulation that regulators have generally sought to achieve. These include ensuring adequate consumer protections, ensuring the integrity and fairness of markets, monitoring the safety and soundness of institutions, and acting to ensure the stability of the overall financial system. However, these goals are not always explicitly set in the federal statutes and regulations that govern these regulators. Having specific goals clearly articulated in

[2]GAO, *Financial Derivatives: Actions Needed to Protect the Financial* System, GAO/GGD-94-133 (Washington, D.C.: May 18, 1994).

[3]GAO, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO-05-61 (Washington, D.C.: Oct. 6, 2004); and *Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure*, GAO-08-32 (Washington, D.C.: Oct. 12, 2007).

legislation could serve to better focus regulators on achieving their missions with greater certainty and purpose, and provide continuity over time.

Given some of the key changes in financial markets discussed in our report—particularly the increased interconnectedness of institutions, the increased complexity of products, and the increasingly global nature of financial markets—Congress should consider the benefits that may result from re-examining the goals of financial regulation and making explicit a set of comprehensive and cohesive goals that reflect today's environment. For example, it may be beneficial to have a clearer focus on ensuring that products are not sold with unsuitable, unfair, deceptive, or abusive features; that systemic risks and the stability of the overall financial system are specifically addressed; or that U.S. firms are competitive in a global environment. This may be especially important given the history of financial regulation and the ad hoc approach through which the existing goals have been established.

We found varying views about the goals of regulation and how they should be prioritized. For example, representatives of some regulatory agencies and industry groups emphasized the importance of creating a competitive financial system, whereas members of one consumer advocacy group noted that reforms should focus on improving regulatory effectiveness rather than addressing concerns about market competitiveness. In addition, as the Federal Reserve notes, financial regulatory goals often will prove interdependent and at other times may conflict.

Revisiting the goals of financial regulation would also help ensure that all involved entities—legislators, regulators, institutions, and consumers—are able to work jointly to meet the intended goals of financial regulation. Such goals and objectives could help establish agency priorities and define responsibility and accountability for identifying risks, including those that cross markets and industries. Policymakers should also carefully define jurisdictional lines and weigh the advantages and disadvantages of having overlapping authorities. While ensuring that the primary goals of financial regulation—including system soundness, market integrity, and consumer protection—are better articulated for regulators, policymakers will also have to ensure that regulation is balanced with other national goals, including facilitating capital raising, innovation, and other benefits that foster long-term growth, stability, and welfare of the United States.

Once these goals are agreed upon, policymakers will need to determine the extent to which goals need to be clarified and specified through rules and requirements, or whether to avoid such specificity and provide regulators with greater flexibility in interpreting such goals. Some reform proposals suggest "principles-based regulation" in which regulators apply broad-based regulatory principles on a case-by-case basis. Such an approach offers the potential advantage of allowing regulators to better adapt to changing market developments. Proponents also note that such an approach would prevent institutions in a more rules-based system from complying with the exact letter of the law while still engaging in unsound or otherwise undesirable financial activities. However, such an approach has potential limitations. Opponents note that regulators may face challenges to implement such a subjective set of principles. A lack of clear rules about activities could lead to litigation if financial institutions and consumers alike disagree with how regulators interpreted goals. Opponents of principles-based regulation note that industry participants who support such an approach have also in many cases advocated for bright-line standards and increased clarity in regulation, which may be counter to a principles-based system. The most effective approach may involve both a set of broad underlying principles and some clear technical rules prohibiting specific activities that have been identified as problematic.

Key issues to be addressed:

- Clarify and update the goals of financial regulation and provide sufficient information on how potentially conflicting goals might be prioritized.
- Determine the appropriate balance of broad principles and specific rules that will result in the most effective and flexible implementation of regulatory goals.

2. ***Appropriately comprehensive.*** **A regulatory system should ensure that financial institutions and activities are regulated in a way that ensures regulatory goals are fully met. As such, activities that pose risks to consumer protection, financial stability, or other goals should be comprehensively regulated, while recognizing that not all activities will require the same level of regulation.**

A financial regulatory system should effectively meet the goals of financial regulation, as articulated as part of this process, in a way that is appropriately comprehensive. In doing so, policymakers may want to consider how to ensure that both the breadth and depth of regulation are appropriate and adequate. That is, policymakers and regulators should consider how to make determinations about which activities and products, both new and existing, require some aspect of regulatory involvement to meet regulatory goals, and then make determinations about how extensive such regulation should be. As we noted in our report, gaps in the current level of federal oversight of mortgage lenders, credit rating agencies, and certain complex financial products such as CDOs and credit default swaps likely have contributed to the current crisis. Congress and regulators may also want to revisit the extent of regulation for entities such as banks that have traditionally fallen within full federal oversight but for which existing regulatory efforts, such as oversight related to risk management and lending standards, have been proven in some cases inadequate by recent events. However, overly restrictive regulation can stifle the financial sectors' ability to innovate and stimulate capital formation and economic growth. Regulators have struggled to balance these competing objectives, and the current crisis appears to reveal that the proper balance was not in place in the regulatory system to date.

Key issues to be addressed:

- Identify risk-based criteria, such as a product's or institution's potential to harm consumers or create systemic problems, for determining the appropriate level of oversight for financial activities and institutions.
- Identify ways that regulation can provide protection but avoid hampering innovation, capital formation, and economic growth.

3. ***Systemwide focus*. A regulatory system should include a mechanism for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk or the institutions in which it is created.**

A regulatory system should focus on risks to the financial system, not just institutions. As noted in our report, with multiple regulators primarily responsible for individual institutions or markets, none of the financial regulators is tasked with assessing the risks posed across the entire financial system by a few institutions or by the collective activities of the industry. The collective activities of a number of entities—including mortgage brokers, real estate professionals, lenders, borrowers, securities underwriters, investors, rating agencies and others—likely all contributed to the recent market crisis, but no one regulator had the necessary scope of oversight to identify the risks to the broader financial system. Similarly, once firms began to fail and the full extent of the financial crisis began to become clear, no formal mechanism existed to monitor market trends and potentially stop or help mitigate the fallout from these events.

Having a single entity responsible for assessing threats to the overall financial system could prevent some of the crises that we have seen in the past. For example, in its Blueprint for a Modernized Financial Regulatory Structure, Treasury proposed expanding the responsibilities of the Federal Reserve to create a "market stability regulator" that would have broad authority to gather and disclose appropriate information, collaborate with other regulators on rulemaking, and take corrective action as necessary in the interest of overall financial market stability. Such a regulator could assess the systemic risks that arise at financial institutions, within specific financial sectors, across the nation, and globally. However, policymakers should consider that a potential disadvantage of providing the agency with such broad responsibility for overseeing nonbank entities could be that it may imply an official government support or endorsement, such as a government guarantee, of such activities, and thus encourage greater risk taking by these financial institutions and investors.

Regardless of whether a new regulator is created, all regulators under a new system should consider how their activities could better identify and address systemic risks posed by their institutions. As the Federal Reserve Chairman has noted, regulation and supervision of financial institutions is a critical tool for limiting systemic risk. This will require broadening the focus from individual safety and soundness of institutions to a systemwide oversight approach that includes potential systemic risks and weaknesses.

A systemwide focus should also increase attention on how the incentives and constraints created by regulations affects risk taking throughout the business cycle, and what actions regulators can take to anticipate and mitigate such risks. However, as the Federal Reserve Chairman has noted, the more comprehensive the approach, the more technically demanding and costly it would be for regulators and affected institutions.

<u>Key issues to be addressed:</u>

- Identify approaches to broaden the focus of individual regulators or establish new regulatory mechanisms for identifying and acting on systemic risks.

- Determine what additional authorities a regulator or regulators should have to monitor and act to reduce systemic risks.

4. ***Flexible and adaptable.*** **A regulatory system should be adaptable and forward-looking such that regulators can readily adapt to market innovations and changes and include a mechanism for evaluating potential new risks to the system.**

A regulatory system should be designed such that regulators can readily adapt to market innovations and changes and include a formal mechanism for evaluating the full potential range of risks of new products and services to the system, market participants, and customers. An effective system could include a mechanism for monitoring market developments—such as broad market changes that introduce systemic risk, or new products and services that may pose more confined risks to particular market segments—to determine the degree, if any, to which regulatory intervention might be required. The rise of a very large market for credit derivatives, while providing benefits to users, also created exposures that warranted actions by regulators to rescue large individual participants in this market. While efforts are under way to create risk-reducing clearing mechanisms for this market, a more adaptable and responsive regulatory system might have recognized this need earlier and addressed it sooner. Some industry representatives have suggested that principles-based regulation would provide such a mechanism. Designing a system to be flexible and proactive also involves determining whether Congress, regulators, or both should make such determinations, and how such an approach should be clarified in laws or regulations.

Important questions also exist about the extent to which financial regulators should actively monitor and, where necessary, approve new financial products and services as they are developed to ensure the least harm from inappropriate products. Some individuals commenting on this framework, including industry representatives, noted that limiting government intervention in new financial activities until it has become clear that a particular activity or market poses a significant risk and therefore warrants intervention may be more appropriate. As with other key policy questions, this may be answered with a combination of both approaches, recognizing that a product approval approach may be appropriate for some innovations with greater potential risk, while other activities may warrant a more reactive approach.

Key issues to be addressed:

- Determine how to effectively monitor market developments to identify potential risks; the degree, if any, to which regulatory intervention might be required; and who should hold such a responsibility.

- Consider how to strike the right balance between overseeing new products as they come onto the market to take action as needed to protect consumers and investors, without unnecessarily hindering innovation.

5. ***Efficient and effective*. A regulatory system should provide efficient oversight of financial services by eliminating overlapping federal regulatory missions, where appropriate, and minimizing regulatory burden while effectively achieving the goals of regulation.**

A regulatory system should provide for the efficient and effective oversight of financial services. Accomplishing this in a regulatory system involves many considerations. First, an efficient regulatory system is designed to accomplish its regulatory goals using the least amount of public resources. In this sense, policymakers must consider the number, organization, and responsibilities of each agency, and eliminate undesirable overlap in agency activities and responsibilities. Determining what is undesirable overlap is a difficult decision in itself. Under the current U.S. system, financial institutions often have several options for how to operate their business and who will be their regulator. For example, a new or existing depository institution can choose among several charter options. Having multiple regulators performing similar functions does allow for these agencies to potentially develop alternative or innovative approaches to regulation separately, with the approach working best becoming known over time. Such proven approaches can then be adopted by the other agencies. On the other hand, this could lead to regulatory arbitrage, in which institutions take advantage of variations in how agencies implement regulatory responsibilities in order to be subject to less scrutiny. Both situations have occurred under our current structure.

With that said, recent events clearly have shown that the fragmented U.S. regulatory structure contributed to failures by the existing regulators to adequately protect consumers and ensure financial stability. As we note in our report, efforts by regulators to respond to the increased risks associated with new mortgage products were sometimes slowed in part because of the need for five federal regulators to coordinate their response. The Chairman of the Federal Reserve has similarly noted that the different regulatory and supervisory regimes for lending institutions and mortgage brokers made monitoring such institutions difficult for both regulators and investors. Similarly, we noted in our report that the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

One first step to addressing such problems is to seriously consider the need to consolidate depository institution oversight among fewer agencies. Since 1996, we have been recommending that the number of federal agencies with primary responsibilities for bank oversight be reduced.[4] Such a move would result in a system that was more efficient and improve consistency in regulation, another important characteristic of an effective regulatory system. In addition, Congress could consider the advantages and disadvantages of providing a federal charter option for insurance and creating a federal insurance regulatory entity. We have not studied the issue of an optional federal charter for insurers, but have through the years noted difficulties with efforts to harmonize insurance regulation across states through the NAIC-based structure. The establishment of a federal insurance charter and regulator could help alleviate some of these challenges, but such an approach could also have unintended consequences for state regulatory bodies and for insurance firms as well.

Also, given the challenges associated with increasingly complex investment and retail products as discussed earlier, policymakers will need to consider how best to align agency responsibilities to better ensure that consumers and investors are provided with clear, concise, and effective disclosures for all products.

Organizing agencies around regulatory goals as opposed to the existing sector-based regulation may be one way to improve the effectiveness of the system, especially given some of the market developments discussed earlier. Whatever the approach, policymakers should seek to minimize conflict in regulatory goals across regulators, or provide for efficient mechanisms to coordinate in cases where goals inevitably overlap. For example, in some cases, the safety and soundness of an individual

[4]See GAO, *Bank Oversight: Fundamental Principles for Modernizing the U.S. Structure,* GAO/T-GGD-96-117 (Washington, D.C.: May 2, 1996).

institution may have implications for systemic risk, or addressing an unfair or deceptive act or practice at a financial institution may have implications on the institution's safety and soundness by increasing reputational risk. If a regulatory system assigns these goals to different regulators, it will be important to establish mechanisms for them to coordinate.

Proposals to consolidate regulatory agencies for the purpose of promoting efficiency should also take into account any potential trade-offs related to effectiveness. For example, to the extent that policymakers see value in the ability of financial institutions to choose their regulator, consolidating certain agencies may reduce such benefits. Similarly, some individuals have commented that the current system of multiple regulators has led to the development of expertise among agency staff in particular areas of financial market activities that might be threatened if the system were to be consolidated. Finally, policymakers may want to ensure that any transition from the current financial system to a new structure should minimize as best as possible any disruption to the operation of financial markets or risks to the government, especially given the current challenges faced in today's markets and broader economy.

A financial system should also be efficient by minimizing the burden on regulated entities to the extent possible while still achieving regulatory goals. Under our current system, many financial institutions, and especially large institutions that offer services that cross sectors, are subject to supervision by multiple regulators. While steps toward consolidated supervision and designating primary supervisors have helped alleviate some of the burden, industry representatives note that many institutions face significant costs as a result of the existing financial regulatory system that could be lessened. Such costs, imposed in an effort to meet certain regulatory goals such as safety and soundness and consumer protection, can run counter to other goals of a financial system by stifling innovation and competitiveness. In addressing this concern, it is also important to consider the potential benefits that might result in some cases from having multiple regulators overseeing an institution. For example, representatives of state banking and other institution regulators, and consumer advocacy organizations, note that concurrent jurisdiction—between two federal regulators or a federal and state regulator—can provide needed checks and balances against individual financial regulators who have not always reacted appropriately and in a timely way to address problems at institutions. They also note that states may move more quickly and more flexibly to respond to activities causing harm to consumers. Some types of concurrent jurisdiction, such as enforcement authority, may be less burdensome to institutions than others, such as ongoing supervision and examination.

Key issues to be addressed:

- Consider the appropriate role of the states in a financial regulatory system and how federal and state roles can be better harmonized.
- Determine and evaluate the advantages and disadvantages of having multiple regulators, including nongovernmental entities such as SROs, share responsibilities for regulatory oversight.
- Identify ways that the U.S. regulatory system can be made more efficient, either through consolidating agencies with similar roles or through minimizing unnecessary regulatory burden.
- Consider carefully how any changes to the financial regulatory system may negatively impact financial market operations and the broader economy, and take steps to minimize such consequences.

6. ***Consistent consumer and investor protection.* A regulatory system should include consumer and investor protection as part of the regulatory mission to ensure that market participants receive consistent, useful information, as well as legal protections for similar financial products and services, including disclosures, sales practice standards, and suitability requirements.**

A regulatory system should be designed to provide high-quality, effective, and consistent protection for consumers and investors in similar situations. In doing so, it is important to recognize important distinctions between retail consumers and more sophisticated consumers such as institutional investors, where appropriate considering the context of the situation. Different disclosures and regulatory protections may be necessary for these different groups. Consumer protection should be viewed from the perspective of the consumer rather than through the various and sometimes divergent perspectives of the multitude of federal regulators that currently have responsibilities in this area.

As discussed in our report, many consumers that received loans in the last few years did not understand the risks associated with taking out their loans, especially in the event that housing prices would not continue to increase at the rate they had in recent years. In addition, increasing evidence exists that many Americans are lacking in financial literacy, and the expansion of new and more complex products will continue to create challenges in this area. Furthermore, regulators with existing authority to better protect consumers did not always exercise that authority effectively. In considering a new regulatory system, policymakers should consider the significant lapses in our regulatory system's focus on consumer protection and ensure that such a focus is prioritized in any reform efforts. For example, policymakers should identify ways to improve upon the existing, largely fragmented, system of regulators that must coordinate to act in these areas. This should include serious consideration of whether to consolidate regulatory responsibilities to streamline and improve the effectiveness of consumer protection efforts. Another way that some market observers have argued that consumer protections could be enhanced and harmonized across products is to extend suitability requirements—which require securities brokers making recommendations to customers to have reasonable grounds for believing that the recommendation is suitable for the customer—to mortgage and other products. Additional consideration could also be given to determining whether certain products are simply too complex to be well understood and make judgments about limiting or curtailing their use.

Key issues to be addressed:

- Consider how prominent the regulatory goal of consumer protection should be in the U.S. financial regulatory system.
- Determine what amount, if any, of consolidation of responsibility may be necessary to enhance and harmonize consumer protections, including suitability requirements and disclosures across the financial services industry.
- Consider what distinctions are necessary between retail and wholesale products, and how such distinctions should affect how they are regulated.
- Identify opportunities to protect and empower consumers through improving their financial literacy.

7. ***Regulators provided with independence, prominence, authority, and accountability.* A regulatory system should ensure that regulators have independence from inappropriate influence; have sufficient resources, clout, and authority to carry out and enforce statutory missions; and are clearly**

accountable for meeting regulatory goals.

A regulatory system should ensure that any entity responsible for financial regulation is independent from inappropriate influence; has adequate prominence, authority, and resources to carry out and enforce its statutory mission; and is clearly accountable for meeting regulatory goals. With respect to independence, policymakers may want to consider advantages and disadvantages of different approaches to funding agencies, especially to the extent that agencies might face difficulty remaining independent if they are funded by the institutions they regulate. Under the current structure, for example, the Federal Reserve primarily is funded by income earned from U.S. government securities that it has acquired through open market operations and does not assess charges to the institutions it oversees. In contrast, OCC and OTS are funded primarily by assessments on the firms they supervise. Decision makers should consider whether some of these various funding mechanisms are more likely to ensure that a regulator will take action against its regulated institutions without regard to the potential impact on its own funding.

With respect to prominence, each regulator must receive appropriate attention and support from top government officials. Inadequate prominence in government may make it difficult for a regulator to raise safety and soundness or other concerns to Congress and the administration in a timely manner. Mere knowledge of a deteriorating situation would be insufficient if a regulator were unable to persuade Congress and the administration to take timely corrective action. This problem would be exacerbated if a regulated institution had more political clout and prominence than its regulator because the institution could potentially block action from being taken.

In considering authority, agencies must have the necessary enforcement and other tools to effectively implement their missions to achieve regulatory goals. For example, in a 2007 report we expressed concerns over the appropriateness of having OTS oversee diverse global financial firms given the size of the agency relative to the institutions for which it was responsible.[5] It is important for a regulatory system to ensure that agencies are provided with adequate resources and expertise to conduct

[5]GAO, *Financial Market Regulation: Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration*, GAO-07-154 (Washington, D.C.: Mar. 15, 2007).

their work effectively. A regulatory system should also include adequate checks and balances to ensure the appropriate use of agency authorities. With respect to accountability, policymakers may also want to consider different governance structures at agencies—the current system includes a combination of agency heads and independent boards or commissions—and how to ensure that agencies are recognized for successes and held accountable for failures to act in accordance with regulatory goals.

Key issues to be addressed:

- Determine how to structure and fund agencies to ensure each has adequate independence, prominence, tools, authority and accountability.
- Consider how to provide an appropriate level of authority to an agency while ensuring that it appropriately implements its mission without abusing its authority.
- Ensure that the regulatory system includes effective mechanisms for holding regulators accountable.

8. *Consistent financial oversight.* A regulatory system should ensure that similar institutions, products, risks, and services are subject to consistent regulation, oversight, and transparency, which should help minimize negative competitive outcomes while harmonizing oversight, both within the United States and internationally.

A regulatory system should ensure that similar institutions, products, and services posing similar risks are subject to consistent regulation, oversight, and transparency. Identifying which institutions and which of their products and services pose similar risks is not easy and involves a number of important considerations. Two institutions that look very similar may in fact pose very different risks to the financial system, and therefore may call for significantly different regulatory treatment. However, activities that are done by different types of financial institutions that pose similar risks to their institutions or the financial system should be regulated similarly to prevent competitive disadvantages between institutions.

Streamlining the regulation of similar products across sectors could also help prepare the United States for challenges that may result from increased globalization and potential harmonization in regulatory standards. Such efforts are under way in other jurisdictions. For example, at a November 2008 summit in the United States, the Group of 20 countries pledged to strengthen their regulatory regimes and ensure that all financial markets, products, and participants are consistently regulated or subject to oversight, as appropriate to their circumstances. Similarly, a working group in the European Union is slated by the spring of 2009 to propose ways to strengthen European supervisory arrangements, including addressing how their supervisors should cooperate with other major jurisdictions to help safeguard financial stability globally. Promoting consistency in regulation of similar products should be done in a way that does not sacrifice the quality of regulatory oversight.

As we noted in a 2004 report, different regulatory treatment of bank and financial holding companies, consolidated supervised entities, and other holding companies may not provide a basis for consistent oversight of their consolidated risk management strategies, guarantee competitive neutrality, or contribute to better oversight of systemic risk.[6] Recent events further underscore the limitations brought about when there is a lack of consistency in oversight of large financial institutions. As such, Congress and regulators will need to seriously consider how best to consolidate responsibilities for oversight of large financial conglomerates as part of any reform effort.

Key issues to be addressed:

- Identify institutions and products and services that pose similar risks.
- Determine the level of consolidation necessary to streamline financial regulation activities across the financial services industry.
- Consider the extent to which activities need to be coordinated internationally.

9. *Minimal taxpayer exposure*. A regulatory system should have adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk.

[6] GAO-05-61.

A regulatory system should have adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk. Policymakers should consider identifying the best safeguards and assignment of responsibilities for responding to situations where taxpayers face significant exposures, and should consider providing clear guidelines when regulatory intervention is appropriate. While an ideal system would allow firms to fail without negatively affecting other firms—and therefore avoid any moral hazard that may result—policymakers and regulators must consider the realities of today's financial system. In some cases, the immediate use of public funds to prevent the failure of a critically important financial institution may be a worthwhile use of such funds if it ultimately serves to prevent a systemic crisis that would result in much greater use of public funds in the long run. However, an effective regulatory system that incorporates the characteristics noted above, especially by ensuring a systemwide focus, should be better equipped to identify and mitigate problems before it become necessary to make decisions about whether to let a financial institution fail.

An effective financial regulatory system should also strive to minimize systemic risks resulting from interrelationships between firms and limitations in market infrastructures that prevent the orderly unwinding of firms that fail. Another important consideration in minimizing taxpayer exposure is to ensure that financial institutions provided with a government guarantee that could result in taxpayer exposure are also subject to an appropriate level of regulatory oversight to fulfill their responsibilities.

Key issues to be addressed:

- Identify safeguards that are most appropriate to prevent systemic crises while minimizing moral hazard.
- Consider how a financial system can most effectively minimize taxpayer exposure to losses related to financial instability.

Finally, although significant changes may be required to modernize the U.S. financial regulatory system, policymakers should consider carefully how best to implement the changes in such a way that the transition to a new structure does not hamper the functioning of the financial markets, individual financial institutions' ability to conduct their activities, and consumers' ability to access needed services. For example, if the changes require regulators or institutions to make systems changes, file registrations, or other activities that could require extensive time to complete, the changes could be implemented in phases with specific target dates around which the affected entities could formulate plans. In addition, our past work has identified certain critical factors that should be addressed to ensure that any large-scale transitions among government agencies are implemented successfully.[7] Although all of these factors are likely important for a successful transformation for the financial regulatory system, Congress and existing agencies should pay particular attention to ensuring there are effective communication strategies so that all affected parties, including investors and consumers, clearly understand any changes being implemented. In addition, attention should be paid to developing a sound human capital strategy to ensure that any new or consolidated agencies are able to retain and attract additional quality staff during the transition period. Finally, policymakers should consider how best to retain and utilize the existing skills and knowledge base within agencies subject to changes as part of a transition.

Chair Warren and Members of the Panel, I appreciate the opportunity to discuss these critically important issues and would be happy to answer any questions that you may have. Thank you.

Contact

For further information on this testimony, please contact Orice M. Williams at (202) 512-8678 or williamso@gao.gov, or Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov.

[7]See GAO, *Homeland Security: Critical Design and Implementation Issues*, GAO-02-957T (Washington, D.C.: July 17, 2002).

Appendix I: Agencies and Other Organizations That Reviewed the Draft Report

American Bankers Association
American Council of Life Insurers
Center for Responsible Lending
Commodity Futures Trading Commission
Conference of State Bank Supervisors
Consumer Federation of America
Consumers Union
Credit Union National Association
Department of the Treasury
Federal Deposit Insurance Corporation
Federal Housing Finance Agency
Federal Reserve
Financial Industry Regulatory Authority
Financial Services Roundtable
Futures Industry Association
Independent Community Bankers of America
International Swaps and Derivates Association
Mortgage Bankers Association
National Association of Federal Credit Unions
National Association of Insurance Commissioners
National Consumer Law Center
National Credit Union Administration
National Futures Association
Office of the Comptroller of the Currency
Office of Thrift Supervision
Public Company Accounting Oversight Board
Securities and Exchange Commission
Securities Industry and Financial Markets Association
U.S. PIRG

Related GAO Products

Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System. GAO-09-216. Washington, D.C.: January 8, 2009.

Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency. GAO-09-161. Washington, D.C.: December 2, 2008.

Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed. GAO-08-200. Washington, D.C.: January 24, 2008.

Information on Recent Default and Foreclosure Trends for Home Mortgages and Associated Economic and Market Developments. GAO-08-78R. Washington, D.C.: October 16, 2007.

Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure. GAO-08-32. Washington, D.C.: October 12, 2007.

Financial Market Regulation: Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration. GAO-07-154. Washington, D.C.: March 15, 2007.

Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved. GAO-06-1021. Washington, D.C.: September 19, 2006.

Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers. GAO-06-929. Washington, D.C.: September 12, 2006.

Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure. GAO-05-61. Washington, D.C.: October 6, 2004.

Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending. GAO-04-280. Washington, D.C.: January 30, 2004.

Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk. GAO/GGD-00-3. Washington, D.C.: October 29, 1999.

Bank Oversight: Fundamental Principles for Modernizing the U.S. Structure. GAO/T-GGD-96-117. Washington, D.C.: May 2, 1996.

Financial Derivatives: Actions Needed to Protect the Financial System. GAO/GGD-94-133. Washington, D.C.: May 18, 1994.

GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday afternoon, GAO posts on its Web site newly released reports, testimony, and correspondence. To have GAO e-mail you a list of newly posted products, go to www.gao.gov and select "E-mail Updates."

Order by Phone

The price of each GAO publication reflects GAO's actual cost of production and distribution and depends on the number of pages in the publication and whether the publication is printed in color or black and white. Pricing and ordering information is posted on GAO's Web site, http://www.gao.gov/ordering.htm.

Place orders by calling (202) 512-6000, toll free (866) 801-7077, or TDD (202) 512-2537.

Orders may be paid for using American Express, Discover Card, MasterCard, Visa, check, or money order. Call for additional information.

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Ralph Dawn, Managing Director, dawnr@gao.gov, (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, DC 20548

Public Affairs

Chuck Young, Managing Director, youngc1@gao.gov, (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, DC 20548

Professor WARREN. Thank you, Mr. Dodaro. I really appreciate it.

Thank you, and thank the GAO for your thoughtful and detailed report. I read it with great interest. It has very, very good ideas in it.

If I can, I want to focus on one in particular to get us started with our questions today and that is, you highlight in your report how consumer and investor protection has been distributed across a range of agencies, at the federal level, federal and state, that there are many actors who have some small part of consumer regulation, and that I believe, as you put it, one of the consequences of this is it creates a low priority for many of those agencies who have other responsibilities and has made for ineffective regulation in this area.

You suggest in your report that one agency devoted to consumer financial issues, which would be responsible to the President and to Congress and to the American people, might be a solution to this problem.

Can you say more on the consumer side about how one agency, it would be a very different way to look at this problem, how it might solve some of the problems that you have identified?

Mr. DODARO. Well, first, our work has shown over a period of time that this is an area where, while there are some benefits to having multiple people involved looking at this, and I think this is one area where having the state involvement as well as the federal involvement, to go to Mr. Neiman's opening comment, is a positive development, but there needs to be a better overall structure in place across the federal departments and agencies to be able to deal with this.

I'll ask Rick to elaborate on our work a bit. We don't actually, you know, make a recommendation that this be done but we think it has merit, a lot of merit that should be explored going forward.

Our work has consistently shown, whether we're looking at credit cards, mutual fund fees, or others, that the disclosures to the public aren't clear. They don't really understand these issues. Clearly, this was an issue with the various mortgage products that were put forth on the market in the past.

We've done work saying that the Committee on Financial Literacy that's set up at the federal level doesn't have a strategic plan, isn't funded properly to continue to provide, you know, education in this field as well. So it has a lot of dimensions. Oftentimes it doesn't get as much attention, as we point out in our report, as necessary. So making it a clear priority, setting up a structure again in this overall framework going forward, I think, is a worthy area to be very carefully explored by this panel and then the Congress as it goes forward.

Professor WARREN. Mr. Hillman, would you like to add to that?

Mr. HILLMAN. Yes. I think that the comments that you made are right on target from the standpoint that the consumer protections are really as fragmented as our regulatory system is currently fragmented and that can cause inconsistencies, overlaps, and gaps in ensuring that consumers are best protected, and this current crisis, with what has been taking place with the subprime mortgage market and other areas, has clearly demonstrated that there needs to be improvements in the consumer protection area.

Moving more towards a single regulator to oversee consumer protection areas is definitely an idea that merits additional attention. There are many options with which to establish a new regulatory structure. Moving towards a single regulator or moving towards what is referred to as regulation by objective or a Twin Peaks model where you have a safety and soundness regulator and a consumer protection regulator both afford you opportunities to enhance the visibility of consumer protection issues in a reformed regulatory structure.

So we believe, as a result of our work, that that is a serious issue that needs to be debated to determine how best to ensure consumer protections are delivered in the most effective means.

Professor WARREN. All right. Thank you. I'm going to switch areas just because our time is very limited. You focused, I thought, very helpfully in the report on the importance of identifying and regulating systemic risk, obviously a terrible problem right now, and others have also talked about this, Chairman Frank, the Treasury Department.

Can I ask you to comment just briefly on the question of whether the appropriate entity to identify and regulate systemic risk should be placed within the Fed or within a new regulatory body, a new regulator to look specifically at systemic risk? Do you have a comment on that, please?

Mr. DODARO. Yes, there's various trade-offs associated with making that decision. Obviously the Federal Reserve's focus on monetary policy is important and they need to maintain their independence in that regard.

One of the areas that we've looked at over the past is how some other countries have handled this particular issue. The United Kingdom in particular went to a single financial services authority, a single regulator, while maintaining the Central Bank functions in a separate entity and given the current situation, they are reevaluating some of those issues.

Part of the issue there is how much the Central Bank really needs to know about what's going on within the financial institutions around the country to put them in a monetary policymaking position. So this is an area we don't have a ready answer for you today, but I think it's an area that needs to be carefully considered going forward in the debate because there are some serious tradeoffs associated with providing all of these types of authorities to one entity.

Professor WARREN. Thank you. I appreciate it, and I'm out of time.

Congressman.

Representative HENSARLING. Thank you, Madam Chair. Mr. Dodaro, thank you for appearing today, and thank you again for the quality of the work of the GAO. I find the reports to be helpful, comprehensive.

In the report that I have before me, there is a short discussion, I guess, of our history of the financial regulatory system, a number of observations you have for the framework for this panel and Congress and other policymakers going forward.

What I don't necessarily see, though, is an analysis from GAO on the significant "but for" factors that have led us to the economic turmoil that we see today. I think we're all believers of the adage that those who do not learn the lessons of history are condemned to repeat them. So am I missing that from this work? Was that not in the scope of the work or has GAO come to some conclusions about the primary "but for" causes of our present economic turmoil?

Mr. DODARO. Well, the report does focus on some of the developments that have happened in the financial marketplace that have challenged the regulators, but it was not within the scope of it to talk about all the underlying economic situations that have gone before there.

I would ask if my colleague Ms. Williams could elaborate on that.

Ms. WILLIAMS. No. I think it's accurate that we did not specifically set out in this report to lay out the reasons for the current economic turmoil in the market. We simply used this as an additional data point, in addition to other problems that have existed in the markets over several decades to illustrate this is yet another example that points to serious questions about the regulatory structure.

Representative HENSARLING. In dealing with the issue of consumer protection, on page 18 of your report, you state, "Many consumers that received loans in the last few years did not understand the risk associated with taking out their loans."

After first being elected as a member of Congress, my wife and I purchased what we referred to as an old, expensive condominium in the Alexandria area. My five- and six-year-old referred to it as the itty-bitty teeny-tiny house.

When faced with the real estate closure of that condominium, I remember being given a voluminous amount of documents, almost none of which I've read, notwithstanding the fact that I've actually had a short, un-illustrious legal career and had to read that stuff at one time.

I remember asking the real estate agent who actually reads this stuff, and the answer was about one out of a hundred home purchasers. I said, "Well, who's the one?" And they stated a first-year law student at one of the local law schools.

[Laughter.]

Representative HENSARLING. My question is, should consumers know what mortgage products they sign and can they know? Is there a concept—is it possible for regulators to have/promote effective disclosure, again as opposed to what I would refer to as voluminous disclosure? Has the GAO concluded that consumers can and should understand the risk associated with their mortgage products?

Mr. DODARO. First, we've made a number of recommendations; I'll ask Mr. Hillman to elaborate on those, in a series of products over time, about making the disclosures more understandable to consumers. There's ways to do research on this, to do some testing as to what the consumers would really understand and put in place.

As I've also grown to appreciate over time, some of the disclosures are in, as you mentioned, teeny-tiny condominium—or in teeny-tiny print—so they're even hard to read, but there are a number of ways that we believe and have recommended that the disclosures could be improved over time, and I also, though, would not also overlook the issue of financial literacy training to the population at large over a period of time.

Representative HENSARLING. I see my time is winding down. I'd like to try to squeeze in at least one more question here.

Did the GAO look at the enforcement mechanisms that are in place to deal with mortgage fraud? According to FINCEN, Financial Crimes Enforcement Network, mortgage fraud has increased something along the lines of 1,400 percent in this decade. A lot of predatory lending, frankly a lot of predatory borrowing. I think according to FINCEN a majority of the mortgage fraud occurred from borrowers misrepresenting their income, misrepresenting their assets, misrepresenting their occupancy.

Anecdotally, I've spoken with a number of U.S. Attorneys, Assistant U.S. Attorneys. They're focused on terrorism. Unless you're into seven and eight figures fraud, they don't even look at it.

So has the GAO undertaken a look at what would it mean to simply enforce some of the antifraud regulations that are on the books today?

Professor WARREN. Mr. Dodaro, we're out of time. So I'm just going to ask you to limit yourself to just a sentence on this, if you could, or Mr. Hillman.

Mr. HILLMAN. I'd be pleased to respond and your question again is right on target.

We have not done any specific work as relates to the elements of mortgage fraud and the growing nature of that, but we have recently completed two pieces of work in the Bank Secrecy Act area which looks at the extent to which depository institutions are preparing suspicious activity reports and currency transaction reports to help law enforcement agencies tackle that problem and try to determine the most efficient means for depository institutions to comply with the Bank Secrecy Act.

Representative HENSARLING. Thank you. Thank you, Madam Chair.

Professor WARREN. Thank you, Congressman. Mr. Silvers.

Mr. SILVERS. Again, let me express my thanks to the GAO for your assistance to our panel in our brief period of existence and for your own work on the TARP Program.

Your report and your comments before us this morning refer at some length to unregulated both financial institutions and financial products. This follows, I think, a long series of GAO reports dating back to Long Term Capital Management in relation to some of these same issues.

Could you expand on your thinking in that area and with particular reference to the proposition some have raised, including, I think, some witnesses that will follow you, that many of these products and funds are essentially well-known things in new legal garb and ought to be regulated based on economic content rather than legal form?

So, for example, a credit default swap looks a lot like bond insurance.

Mr. DODARO. I think basically, and I'll ask Ms. Williams to elaborate on this a little bit, you know, our work in this area dates back to the 1994 report where we raised questions about the derivatives and the development at that period of time.

I think this is an area where there needs to be—and whatever changes are made to the regulatory framework, you can deal with the existing set of institutions and products now, but looking forward is really the challenge, I believe, going forward. As new products are developed, there needs to be some attention made by the regulators to make a gauge as to what the risk would be, whether it fits in to an already-existing regulatory screen and make a conscious decision of how it should be regulated, and then also monitor that very carefully going forward and make proposals, if they don't already have the authority.

So I think the challenge really there is how to address new products going forward as well as dealing with what we already have.

Mr. SILVERS. Can I, before you ask our colleague to contribute? Are you suggesting that you would support regulatory frameworks, like for example the ′33 and ′34 securities laws, that give broad jurisdiction, broad conceptual jurisdiction to regulators who follow the activity rather than approaches that sort of wall regulators in around particular legal forms?

Mr. DODARO. Yeah. Yes, I mean, there needs some authorities on a risk-based basis. You don't want to go too far in such a way that it stifles innovation, but there has to be a risk assessment tool built in that we think would provide a better safeguard going forward.

Ms. WILLIAMS. And just to add, we have several elements that really speak to that. That's what we're getting at when we talk about the need for comprehensive regulation as well as flexible and nimble and that's to allow the structure to adjust as entities and products morph and to be able to follow the economic substance of the product and also look to the institution and gauge its impact on the overall financial system and not be locked into a statutory definition.

Mr. SILVERS. Would I be correct, in following up with that, that you would look in this respect to regulation, for example, with a particular financial product or institution that currently is outside the regulatory scheme, that you would look both at, for example, transparency, accountability and capital requirements as required by the particular activity going on? Am I clear in what I'm asking?

Ms. WILLIAMS. I would think that would have to be part of the debate. As you decide how far to go with regulating that particular entity, based on its risk to the system, you would have to evaluate if it would be appropriate for all of those items that you listed to be applied.

Mr. SILVERS. And there's really two levels here. One is in the individual regulatory scheme that would be put in place, but also this entity that would focus on systemic risk would also have some responsibilities in this area and to coordinate with the individual regulatory entities.

Coming to the systemic risk question, one item in the debate that's not, I think, been entirely clear and focused but seems quite important to me is the approach to systemic risk regulation, whether one essentially tries to identify systemically-significant institutions ex-ante, in advance, and regulate them with special—bring special regulatory tools to bear in advance or whether you—whether it is better not to do that, whether it's better to essentially act—determine who's systemically significant in midst of crisis, which is, I think, essentially what we've done recently, what's your thinking about that question?

Mr. DODARO. Two thoughts. One, I think in putting a new regulatory structure in place right now, there has to be a recognition of these large financial conglomerate entities that do in fact right now have significance to the system at large and there has to be an appropriate structure put in place to deal with that going forward, recognizing we're in a global environment and we need to have those entities to be competitive, but it shouldn't be static.

I think one thing that's really surprised everybody is the speed in which these things have happened and you can't wait to be in a reactive posture. That is just not going to serve us well. We need to put a durable system in place that's going to be able to recognize what we already know but yet be flexible enough to be proactive going forward if we're really going to mitigate things, given the current globalized environment.

Mr. SILVERS. Thank you.

Professor WARREN. Thank you. Senator Sununu.

Senator SUNUNU. Mr. Dodaro, I'm going to give you an opportunity here now to give us some good news.

[Laughter.]

Senator SUNUNU. In your evaluation of the regulatory system and the events that led up to the current crisis, what did you find that operated effectively? What seemed to be working, and what best practices within our regulatory structure should we look to expand or reinforce?

Mr. DODARO. Well, I think, you know, basically we have a regulatory system, you know, where the regulators are, you know, developing mechanisms to try to coordinate with one another to deal with some of the things. So I think the dialogue among the regulators has improved, although it hasn't gotten to the point of where we would recognize that it's the most effective and efficient way to be able to handle the system going forward.

I think in the current environment and dealing with the situation, the regulators have, you know, acted, I think, to try to deal with and stem and mitigate the effects of the current system going forward with the tools that they have at their disposal to be able to do that and to have acted, you know, in order to try to deal with some of the issues going forward.

There are a lot of very talented people in the financial regulatory area. We have a lot of, you know, well-intended systems in place to be able to do this. In areas where there's been traditional oversight, for example, in the commercial banking industry, we think some of those things have worked, you know, effectively over time, you know, given some of the incremental changes that you mentioned.

I would ask just Rick or Orice if I've missed anything. I don't want to miss any good news.

Mr. HILLMAN. I'd just like to reiterate what Gene was saying in that, given the fragmented regulatory structure that we currently have in place, one of the major benefits of that fragmented structure is that these individual regulators have deep pools of knowledge and an understanding of their individual markets that they're overseeing. So in this particular financial crisis, given the more effective coordination that has taken place across regulators, between the Department of the Treasury and the Federal Reserve, including the Federal Deposit Insurance Corporation, in their particular areas of expertise and the authority that they provide, this has allowed for a more concerted strategy to address the case-by-case problems that have been confronting our financial markets over this past summer.

Senator SUNUNU. In Recommendation Number 5, you talk about the importance of eliminating overlap. Could you give us an example of specific areas where you saw this overlap and perhaps some of the problems it created?

Mr. DODARO. Basically, the one area where we've recommended that it be dealt with is in the banking area. Right now, you have five entities that have responsibilities at the federal level and in that regard, I think there's some merit of looking at that. In the futures and the security areas, the SEC and the Commodities Future Trading Commission could be considered for consolidation as well. Those would be the two primary areas that we would highlight as meriting consideration.

Senator SUNUNU. On the issue of consumer safety, Mr. Hillman used the phrase "working to ensure that consumers are best protected" and talked a little bit about the Twin Peaks Model which separates this responsibility for consumer protection.

But that can create significant problems in that there are elements of consumer protection or consumer services that could and would have a direct effect on the safety and soundness of the institution. It would be a mistake to have an agency or an organization responsible for those consumer protection initiatives without also having an obligation and a responsibility to think through exactly what the effect on this regulation would be on safety and soundness.

How do you reconcile that problem and how can you advocate a Twin Peaks Model if it separates those two obligations and responsibilities?

Mr. HILLMAN. The work that we have done in looking at various alternative regulatory structures suggests to us that there are definite strengths and weaknesses across a whole series of possible options for reforming our regulatory structure and there really, quite frankly, is no silver bullet.

Looking at the Twin Peaks Model where you have oversight by objective, looking at safety and soundness issues or looking at consumer protection issues, it does afford the opportunity to enhance the visibility from a consumer protection standpoint, but your comments are very on target when you suggest that separating consumer protection from the safety and soundness issue can cause problems.

One area, for example, that could be a problem has to do with really assessing reputational risk. There's issues associated with the operations of enterprises and institutions that can cause reputational risk and also harm investors and you really need to look at that at a holistic level. So there's strengths and weaknesses to each approach.

Mr. DODARO. And I think at a minimum, there needs to be clarity of the goals and objectives that are put in place for whatever system's put in place and part of the reason we created the nine characteristics is that there's a tendency to want to gravitate to a quick organizational fix by either centralizing or decentralizing something. Often that doesn't work. It's not as simple as that might seem, even appealing as it may be.

This is one area where once you set what kind of structure you want in place, even if you don't go to a centralized approach, you need to make clear what the responsibilities would be and in the framework in which you're talking about, and I think that's an area where I'd want to make sure that, you know, our message that the minimum requirements need to be really clearly spelled out as to what you expect and what this Congress expects in this area.

Senator SUNUNU. Thank you.

Professor WARREN. Thank you. Mr. Neiman.

Mr. NEIMAN. Yes, I'd like to follow up on that line of questioning because in your written testimony, you do note that unfair consumer lending practices can have safety and soundness implications and I agree with that assertion. And you also noted that if consumer protection and safety and soundness responsibilities were housed in different agencies, that appropriate mechanisms for interagency coordination would be required.

Now, do you have any specific recommendations for processes to overcome those operational challenges or does the fact argue in favor of keeping consumer protection and prudential supervision within the same agency?

Mr. DODARO. Well, a lot would depend—I'll ask Rick, who's been focusing on our work here, to comment. A lot would depend on what type of other changes are made in the system to the financial regulatory apparatus that would be put in place. So you'd have to consider that in arriving at the answer.

But Rick?

Mr. HILLMAN. There's definite trade-offs that take place, depending upon which option you end up choosing. If you're looking at a bifurcation of safety and soundness in consumer protection issues, it's definitely going to put a premium on coordination and communication and collaboration between those entities that have those responsibilities.

If you put it in one organization, you have the opportunity to share expertise and information across those two important issues but then you may lose focus as to what you're really looking to achieve.

So depending upon whichever structure you ultimately move to, Gene is absolutely right, we need to establish what goals need to be in place to ensure effective consumer protection and have those goals drive down the regulatory process to achieve them.

Mr. NEIMAN. In that same section you talk about overlapping jurisdiction of regulators and to a certain extent in certain areas it can be burdensome, but in other areas it can provide appropriate checks and balances. From my experience as a state regulator, I have seen that play an important role where we work very cooperatively and serve with our countervailing federal regulators.

You also indicate that with respect to enforcement activities, that is a less burdensome area, and where I assume what you're getting at is more cops on the beat rather than less is important.

Would you elaborate on the balance between checks and balances and overburdensome regulatory overlap?

Mr. DODARO. Yeah. I think the real goal would be to capitalize and build upon those things that are working well right now and that provide those checks and balances.

I think, you know, our view on overlapping regulations is more at the federal level than it would be between the Federal Government and at the state level. So I'd want to clarify that. I think there's distinct advantages of having the states be involved in this process going forward. We think there are opportunities at the federal level. So you need to preserve the checks and balances.

It's a big system. It's complicated. It's moving fast. States give you a decentralized sort of eyes and ears on the ground across the country and I think you don't want to lose that ability to be able to do that going forward, but that's our—most of the focus is at the federal level.

Mr. NEIMAN. Thank you.

Mr. HILLMAN. And particularly to your point on the checks and balances, while GAO has not made any proposals suggesting how to reform the financial services sector, we have suggested, though, that we need to seriously look at some consolidation of the financial services sector and that is not to say that we are trying to eliminate competition across regulators. That would be an inconsistent reaction to what our view is.

You know, competition across regulator agencies helps to ensure innovative structures within the federal and state levels and in some form would likely be benefited by preserving the regulatory competition that exists. The question is, though, is there too much competition now across the many organizations that exist?

Mr. NEIMAN. Have you addressed in any way the issues around federal preemption of state laws, particularly state consumer laws?

Mr. HILLMAN. We acknowledged in prior work concerns associated with federal preemption, particularly as it relates to the Office of Comptroller of the Currency, and in steps taken earlier this decade to limit visitorial powers associated with states' interaction with national banks and as a result of that work had suggested that the OCC could do a much better job of determining how they could best incorporate state banking authorities and powers within the confines of what they were referring to with their visitorial powers.

Mr. DODARO. We'd be happy to provide that for your record consideration.

Mr. NEIMAN. Thank you.

Professor WARREN. Thank you. Thank you, Mr. Neiman.

That's going to conclude the testimony for Panel 1. The press of time bumps into the magnitude of the task that we have undertaken.

I want to ask if you would be willing to answer written submissions from the panel on the record that we would send to you in the next few days.

Mr. DODARO. We'd be happy to assist this panel in its important task in any way we can. Certainly.

Professor WARREN. Thank you, Acting Comptroller Dodaro, and thank you, Ms. Williams. Thank you, Mr. Hillman. The panel appreciates your taking the time in coming here.

Mr. DODARO. Thank you very much.

Professor WARREN. Thank you again. We now call the second panel, if you'll come forward, please.

Thank you. I'm pleased to welcome our second panel of witnesses. We are joined by Sarah Bloom Raskin, Commissioner of the Maryland Office of Financial Regulation, by Joel Seligman, President of the University of Rochester, Robert J. Shiller, the Arthur M. Okun Professor of Economics at Yale University, Joseph Stiglitz, University Professor, Columbia Business School, Marc Sumerlin, Managing Director and Co-Founder of The Lindsey Group, and Peter J. Wallison, Arthur F. Burns Fellow in Financial Policy Studies of the American Enterprise Institute.

Welcome to all of you. I will dispense with more and just say, can we start? Each of you will have your full statements on the record, of course. If I can ask you to limit your oral remarks to five minutes, and we'll start with Ms. Raskin.

STATEMENT OF MS. SARAH BLOOM RASKIN, COMMISSIONER, MARYLAND OFFICE OF FINANCIAL REGULATION

Ms. RASKIN. Thank you. Good morning, Madam Chair and Members of the Panel. My name is Sarah Bloom Raskin, and I am Maryland's Commissioner of Financial Regulation.

I'm pleased to be today to share a state perspective on regulatory restructuring. While changing our regulatory system will be complex, four simple concepts should guide us. In evaluating any proposed reform of our financial regulatory system, we must ask (1) does it enhance transparency, (2) does it enhance accountability, (3) does it promote the public interest, and (4) does it address systemic risks?

We often hear that the consolidation of financial regulation at the federal level is the modern response to the challenges of our financial system. I want to challenge this idea.

The 6,000+ state chartered banks now control less than 30 percent of the assets in our banking system, but they make up 70 percent of all U.S. banks. Thus, while these institutions may be smaller than the international organizations now making headlines and winning bail-outs, they are absolutely critical to the communities they serve.

Since the enactment of nationwide banking, the states have developed a highly-coordinated system of state-to-state and state-to-federal bank supervision. This is a model that embodies the American dynamic of both vertical and horizontal checks and balances, an essential dynamic that has been sharply missing from certain areas of federal financial regulation with devastating consequences for all of us.

Remember the ultimate Madisonian theory behind separated powers. This design would restrain ambitions, prevent capture by specific factions and avert corruption. The very definition of tyranny, Madison thought, was the collapse of all powers into one.

The problems we face today do not come from regulatory federalism, but, rather, from the convergence of regulatory centralization and good old-fashioned regulatory capture. Bank regulators like to say that our job is to take away the punch bowl once the party really gets going, but our federal banking regulators made themselves the ruling chaperons of the party and worked with their friends on Wall Street to spike the punch bowl.

The current crisis has thus revealed shocking defects in regulatory and political will in Washington. Perhaps it is true, as the GAO asserts, that the gaps in our divided regulatory structure made it more difficult to understand the gravity of the risks that were building in the system. Perhaps. But the disasters we have experienced are not failures of structure. They are failures of execution, political will, and policy.

I do not want to discount the need for significant regulatory changes and we outline these gaps in our submitted testimony, but those reforms will not address the underlying problems if we fail to understand and address why the federal system did not adequately respond.

From the state perspective, it's not been clear for many years exactly who was hosting the party, who was chaperoning and who the special guests were. The nation's largest and most influential financial institutions have themselves been major contributing factors in our regulatory system's failure to respond to this crisis.

From our foxholes at the state level, we have watched the regulatory apparatus in Washington show tell-tale signs of classic regulatory capture, political, economic and intellectual capture, by the regulated industry.

If this is right, a consolidation of regulatory authority at the federal level would only exacerbate rather than relieve our troubles. From this standpoint, many of the policies of TARP and other federal responses to contain this crisis interfere with our ability to prevent the next crisis.

It would be like saying in the wake of Hurricane Katrina and its aftermath that the solution is to get rid of local fire departments and first responders and centralize more authority and power in FEMA. Regulatory capture becomes more rather than less likely with a consolidated regulatory structure.

It was the states that attempted to check the unhealthy evolution of the mortgage market and apply needed consumer protections to the tidal wave of subprime lending. It was the states and the FDIC that were a check on the flawed assumptions of the Basel II Capital Accord.

Professor WARREN. Ms. Raskin, your time is up. Can I ask you to conclude?

Ms. RASKIN. Yes, I'll finish up. The lesson of this crisis should be that these checks need to be enhanced, multiplied and reinforced, not eliminated.

If we've learned nothing else from this experience, we've learned that big organizations have big problems and as you consider your responses to this crisis, I ask that you consider reforms that promote diversity and create new incentives for the smaller, less-troubled elements of our financial system rather than rewarding the largest and most reckless. At the state level, we're constantly pursuing methods of supervision and regulation. I appreciate your work toward this goal and I thank you for inviting me to share my views today.

[The prepared statement of Ms. Raskin follows:]

PREPARED STATEMENT, SARAH BLOOM RASKIN, COMMISSIONER, MARYLAND OFFICE OF FINANCIAL REGULATION

Introduction

Good morning, Chairperson Warren and members of the Congressional Oversight Panel. My name is Sarah Bloom Raskin, and I am the Maryland Commissioner of Financial Regulation. I also serve as the Chair of the Conference of State Bank Supervisors (CSBS) Legislative Committee and of the CSBS Task Force on Regulatory Restructuring. I am pleased to be here today to offer a state perspective on our nation's financial regulatory structure -- its strengths and its deficiencies, and suggestions for reform.

Before I begin, I would like to commend the GAO for its self-initiated report on this challenging topic and for its outreach to the many stakeholders in this complex structure. As the GAO report details, states play a significant role in almost all aspects of financial regulation. My comments, however, will reflect my own experience as a state regulator of banking, mortgages and consumer finance.

As we work through a federal response to this financial crisis, including the TARP, I hope we carry forward a renewed understanding that the concentration of financial power and a lack of transparency are not in the long-term interests of our financial system, our economic system or our democracy. This lesson is one our country has had to learn in almost every generation, and I hope that the current lesson will benefit future generations. Yes, our largest and most complex institutions seem critical to our global competitiveness; but this nation's true long-term competitive edge has always been its meritocracy and its freedom of opportunity – the economic democracy of the marketplace.

While changing our regulatory system will be far from simple, some fairly simple concepts should guide these reforms. In evaluating any governmental reform of our financial regulatory system, we must ask these questions:

- does it preserve and enhance transparency?
- does it preserve and enhance accountability?
- does it promote the public interest?
- does it address the systemic risks that threaten balanced growth, fair competition, and the stable flow of commerce?

We have often heard – as you may hear today -- that the consolidation of financial regulation at the federal level is the "modern" answer to the challenges our financial system. I am here to challenge this assumption, and ask you to challenge it as well. For your consideration, I have attached a set of goals that state regulators have endorsed, through CSBS, for regulatory reform.

<u>Background on State Supervision</u>

As you may know, states charter and regulate more than 70 percent of all U.S. banks, in coordination with the FDIC and Federal Reserve. The rapid consolidation of the industry over the past decade, however, has created a system in which a handful of large national banks control the vast majority of assets in the system. The more than 6,000 banks supervised and regulated by the states now represent less than 30 percent of the assets of the banking system. While these institutions may be smaller than the vast international organizations now making headlines, they are critical to the communities they serve, and are sometimes the only source of credit for local households, businesses, and farms.

Since the enactment of nationwide banking in 1994, the states, working through CSBS, have developed a highly coordinated system of state/state and state-federal bank supervision. This is a model that has served this nation well, embodying our uniquely American dynamic of checks and balances – a dynamic, I suggest, that has been missing from certain areas of federal financial regulation, with devastating consequences.

The dynamic of state and federal supervision for state-chartered banks allows for new businesses to enter the market, while maintaining consistent nationwide standards and systemic risk assessment and moderation.

In addition to regulating banks, my office supervises the residential mortgage industry, as do most state banking departments. All 50 states and the District of Columbia now provide some regulatory oversight of the residential mortgage industry. The states currently manage over 88,000 mortgage company licenses, over 68,000 branch licenses, and approximately 357,000 loan officer licenses. Over the past five years, the states have worked, again through CSBS, to coordinate the multistate supervision of the mortgage industry in a manner similar to the structure we have created for commercial bank supervision.

The Roots of our Financial Crisis

While many have said that this financial crisis started in the housing sector, I suggest that it culminated in housing -- that the bursting of our housing bubble was not a cause but an effect, and one that exposed an unsustainable system of finance. Housing policies may have enabled this crisis, but they did not cause it.

In short, we subjected housing to the boom-and-bust cycles of the capital markets. When the housing bubble burst, it proved what we had long suspected: that the leverage created by the boom was unsustainable; that the network of interdependence among our largest financial institutions was unmanageable; and that the lack of transparency of financial innovations such as the over-the-counter credit derivatives greatly amplified the risks to the system.

As always, the warning signs always seem much clearer in hindsight, but warning signs were visible to those of us who were looking. The bankruptcy of Orange County, the collapse of Long Term Capital Management and the Asian, Mexican and Russian debt crises were all object lessons in the dangers of a lack of transparency, excessive leverage and unmanageable systemic risk. At the state level, we battled predatory lenders for almost a decade, only to be told that our local concerns were less important than the demands of the modern global marketplace. It is an old saying among bank regulators that our job is to take away the punch bowl once the party really gets going. That is not an easy call to make, and it was particularly difficult in the run-up to this financial crisis, as both Wall Street and monetary policy were spiking the punch bowl.

Yes, the current crisis has both revealed and created weaknesses and gaps in our regulatory system; but even more, I submit that it reveals the gap in regulatory and political will in Washington. Perhaps the resilience of our financial system during previous crises gave policy makers and regulators not only a false sense of security, but also a greater willingness to defer to powerful interests in the financial industry who assured them that all was well.

It may be, as the GAO asserts, that gaps in our complex regulatory structure made it more difficult to understand the gravity of the risks that were building in the system. The failings that we see, however, were not failures of structure, but failures of execution. I do not want to discount the need for significant regulatory changes, but those reforms will not address the underlying problems if we fail to understand and address why the federal system did not adequately respond to warning signs.

From the state perspective, it has not been clear for many years exactly who was controlling the punch bowl. What is clear is that the nation's largest and most influential financial institutions have themselves been major contributing factors in our regulatory system's failure to respond to this crisis. At the state level, we have sometimes perceived an environment at the federal level that is skewed toward facilitating the business models and viability of our largest financial institutions rather than promoting the strength of the consumer or our diverse economy.

If this bias does exist, consolidation of regulatory authority at the federal level could leave our regulatory more vulnerable to regulatory capture.

More specifically, regulatory capture by a variety of interests – philosophical, intellectual or otherwise – becomes more rather than less likely with a consolidated regulatory structure. It was the states that attempted to check the unhealthy evolution of the mortgage market and apply needed consumer protections to subprime lending. And it was the states and the FDIC that were a check on the flawed assumptions of the Basel II capital accord. The lesson of this crisis should be that these checks need to be enhanced, not eliminated.

We cannot reduce systemic risk by building a bigger system, and we find ourselves here today because the federal government has so far proved itself incapable of managing systemic risk. While this crisis has demanded a dramatic response from the federal government, the short-term result of many of these programs, including the TARP, has been to create even larger and more complex institutions and greater systemic risk. These responses have created extreme disparity in the treatment of financial institutions, with the government protecting those deemed to be too big or too complex to fail at the expense of smaller institutions, and perhaps of the diversity of our financial system.

Our state-chartered banks may be too-small-to-care at the federal level – but where I sit, in our cities and communities, they are too important to ignore. It is exactly the same dynamic that told us that the plight of the individual homeowner trapped in a predatory loan was less important than the needs of an equity market hungry for new mortgage-backed securities. I cannot help but believe the outcome of this attitude will be equally devastating.

I do not agree with the GAO report's unstated assumption that federal regulatory reforms can address the systemic risk posed by our largest and most complex institutions. If these institutions are too large or complex to fail, the government must give preferential treatment to prevent these failures, and that preferential treatment distorts and harms the marketplace, with potentially disastrous consequences.

To return to the housing element of this crisis, our experience with Fannie Mae and Freddie Mac exemplifies this problem. Large systemic institutions such as Fannie and Freddie inevitably garner advantages and political favor, and the lines between government and industry blur in ways that do not reflect American values of fair competition and merit-based success.

Certainly, significant weaknesses exist in our current regulatory structure. Disagreement among federal agencies has made it more difficult to respond to problems, and the federal government's unique role in chartering financial institutions has created a sometimes unhealthy unbalanced competition with the states. As GAO has noted, incentives need to be better aligned to promote accountability, a fair and competitive market, and consumer protection.

Needed Regulatory Reforms

Systemic Supervision/Capital Requirements

As we evaluate our regulatory structure, we must examine the linkages between the capital markets, the traditional banking sector and other financial services providers. Our top priority for reform must be a better understanding of systemic risks. The federal government must facilitate the transparency of financial markets if we are to create a financial system in which stakeholders can understand and manage their risk. Congress should establish clear expectations about which regulatory authority or authorities are responsible for assessing risk and for using the necessary regulatory tools to address and mitigate risk.

Congress and the regulatory agencies must also consider how the federal government itself may actually contribute to systemic risk -- either by promoting greater industry consolidation or through policies that may increase risks to the system. As I suggested earlier, there may be some institutions whose size or complexity make their risks too large to effectively manage or regulate. Regulators and Congress should contemplate whether breaking up these institutions is in the best interest of the marketplace and the public.

From my perspective as a bank regulator, capital and leverage ratios are essential tools for managing risk. Federal regulation needs to prevent capital arbitrage among institutions that pose systemic risks, and financial institutions whose activities or relationships pose these risks should hold more capital, not less.

Facilitate Orderly Failures of Institutions that Pose Systemic Risks

The FDIC, in the case of insured depositories, and the Federal Reserve, for non-depository systemic institutions, must have the authority and resources to manage the failure of institutions that pose the largest systemic risks in an orderly manner. Since the creation of the FDIC, the states and the federal government have been able to address failures in a manner that both preserves market discipline and consumer confidence. This standard should apply to all institutions.

A Roadmap for Unwinding Federal Liquidity Assistance and Systemic Responses

Treasury and the Federal Reserve must provide a plan for how to unwind the various programs established to provide liquidity and prevent systemic failure. In particular, you asked if these programs are consistent with or advance needed systemic reforms.

My response is, "I hope not." Unfortunately, attempts to avert crisis through liquidity programs have focused on the needs of the largest institutions, without considering the unintended consequences for our diverse system of financial institutions. Put simply, the government is now in the business of picking winners and losers. In the extreme, these decisions determine survival, but they also affect the overall competitive landscape and relative health and profitability of institutions. The federal government should develop a plan that promotes fair and equal competition, rather than sacrificing the diversity of our financial industry to save those deemed systemic.

Preserve and Enhance Checks and Balances/Forge a New Era of Cooperative Federalism

The state system of chartering and regulation has always been a key check on the concentration of financial power, as well as a mechanism to ensure that our banking system remains responsive to local economies' needs and accountable to the public. The state system has fostered a diversity of institutions that has been a source of stability and strength for our country. To promote a strong and diverse system of banking – one that can survive inevitable economic cycles and absorb failures – preservation of state-chartered banking should be a high priority.

One lesson we should learn from this crisis is that nationalization of supervision and applicable law is not the answer. For those who were listening, the states provided plenty of warning signs. The flurry of state predatory lending laws and new state regulatory structures for lenders and mortgage brokers funded by banks and the capital markets were indicators that things were not right in our mortgage lending industry. It would be a cruel irony to respond to this lesson by eliminating the early warning signs that the states provide. Just as checks and balances are a vital part of our democratic government, they serve an equally important role in our financial regulatory structure. The United States boasts one of the most powerful and dynamic economies in the world because of those checks and balances, not despite them.

Most importantly, it serves the consumer interest to preserve the states' role in financial regulation. While I recognize that the mortgage market is a nationwide industry with international implications, local economies and individual homeowners are most affected by mortgage market fluctuations. State regulators must remain active participants in mortgage supervision because of our knowledge of local economies, and our ability to react quickly and decisively to protect consumers.

A single regulator might have all the authority imaginable, but never use it – or use it in a way that cripples the system. The key to the success of our financial system is not only authority, but also accountability. What our founders recognized when establishing our federal system remains as true now as it was 230 years ago – the federal government needs to be accountable. Leading up to this crisis, the states tried to serve this function, but were too often silenced by federal regulatory preemption.

Congress needs to clarify that consumer protections apply equally to all market participants. State laws should not and cannot be preempted for a favored class of institutions. To preserve a responsive system, the states must be able to continue to innovate in consumer protections and regulation.

The federal government would better serve our economies and consumers by advancing a new era of cooperative federalism. The SAFE Mortgage Licensing Act enacted by the last Congress provides a model for the federal government in achieving systemic goals of high regulatory standards and a nationwide regulatory roadmap while preserving state authority for innovation and enforcement.

I have attached CSBS congressional testimony on the challenges posed by preemption and background on the SAFE Act.

Consumer Protection/Enforcement

More, rather than fewer, resources are needed to promote consumer protection. Congress should establish a mechanism among the financial regulators for identifying and responding to emerging consumer issues. This mechanism, perhaps through the FFIEC, should include active state regulator and law enforcement participation and develop coordinated responses. The coordinating federal entity should report to Congress regularly. The states must retain the right to pursue independent enforcement actions against all financial institutions as an appropriate check on the system.

Mortgage Origination and Lending

The states have invested considerable effort and resources over the past five years to address regulatory gaps in our system of mortgage lending. I've attached a document highlighting the numerous state initiatives to improve mortgage regulation as well as charts showing trends in state enforcement actions. Of note, in 2007 the states took nearly 6,000 enforcement actions against mortgage brokers and lenders.

As previously mentioned, last year Congress helped further the goal of closing regulatory gaps through passage of the SAFE Mortgage Licensing Act, which established minimum licensing and regulatory standards and created mechanisms and set expectations for greater state/state and state/federal regulatory coordination.

Congress should complete this process by enacting a federal predatory lending standard. A federal standard should allow for further state refinements in lending standards and be enforceable by state and federal regulators. Additionally, a federal lending standard should clarify expectations of the obligations of securitizers.

Foreclosure Prevention/Mortgage Servicing

States have also led the way in efforts to hold mortgage servicers more accountable. This is an area where, at a minimum, more cooperative federalism is needed. In July 2007 state attorneys general and bank regulators, concerned about growing foreclosures and frustrated with a lack of transparency in servicer loss mitigation activities, began a dialogue with the largest subprime servicers in the U.S. This led to a data collection effort by the states to better understand how servicers were working with borrowers to prevent a snowballing foreclosure crisis. The initial federal response was to tell federally regulated servicers not to respond to state requests for information. Our collective objective of avoiding foreclosure and the deepening of the housing crisis would be much better served if the Treasury and its regulatory agencies worked more cooperatively toward this goal. I have attached testimony on this topic and reports from the State Foreclosure Prevention Working Group.

Conclusion

Chairperson Warren and members of the panel, the task before us is a daunting one. The current crisis is the result of well over a decade's worth of policies that promoted consolidation, uniformity, preemption and the needs of the global marketplace over those of the individual consumer.

If we have learned nothing else from this experience, we have learned that big organizations have big problems. As you consider your responses to this crisis, I ask that you consider reforms that promote diversity and create new incentives for the smaller, less troubled elements of our financial system, rather than rewarding the largest and most reckless.

At the state level, we are constantly pursuing methods of supervision and regulation that promote safety and soundness while making the broadest possible range of financial services available to all members of our communities. We appreciate your work toward this common goal, and thank you for inviting us to share our views today.

CSBS Principles of Regulatory Reform

As a means of evaluating proposals that will be advanced to restructure our nation's regulatory system, the Conference of State Bank Supervisors believes the following principles must be adhered to:

The structure of the regulatory system should:

1. Usher in a new era of cooperative federalism, recognizing the rights of states to protect consumers and reaffirming the state role in chartering and supervising financial institutions.

2. Foster supervision that is tailored to the size, scope and complexity of the institution and the risk they pose to the financial system.

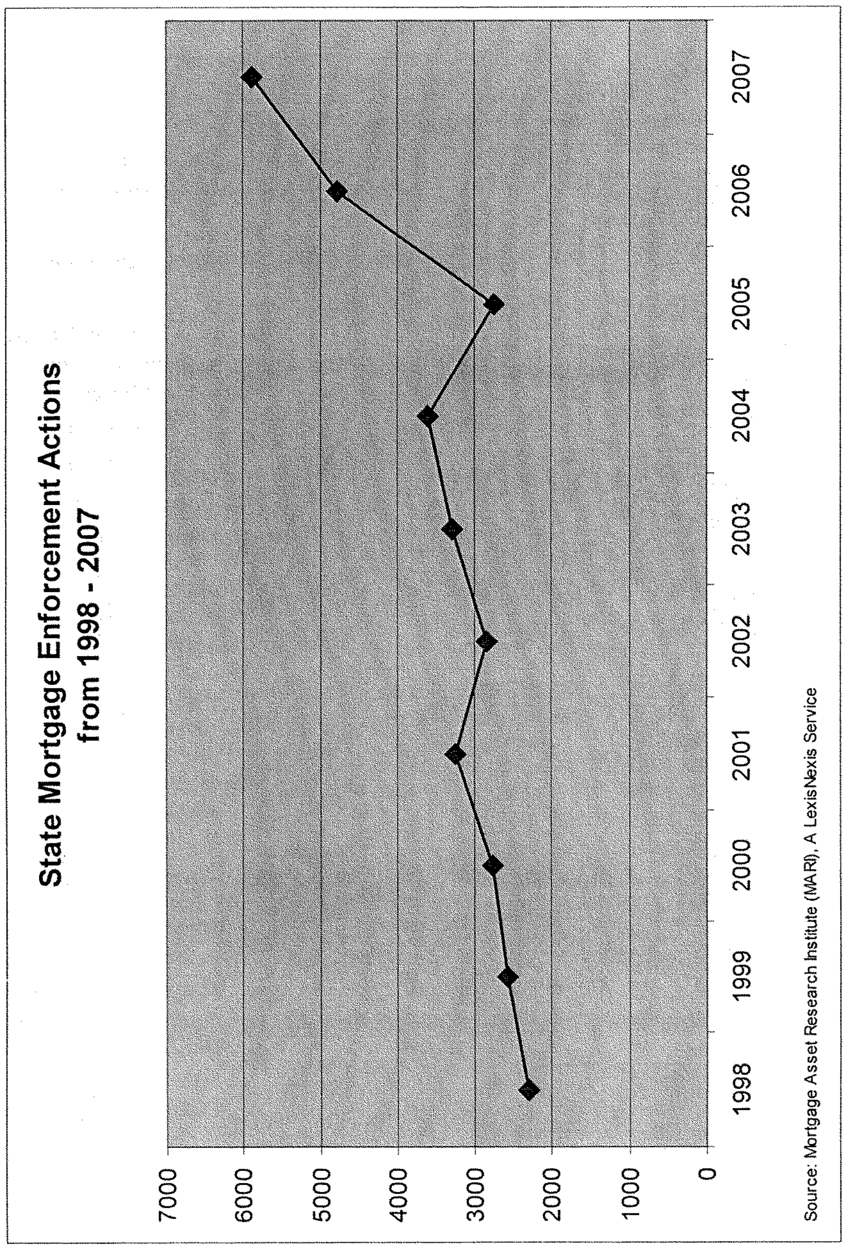
3. Assure the promulgation and enforcement of consumer protection standards that are applicable to both state and nationally chartered financial institutions and are enforceable by locally-responsive state official against all such institutions.

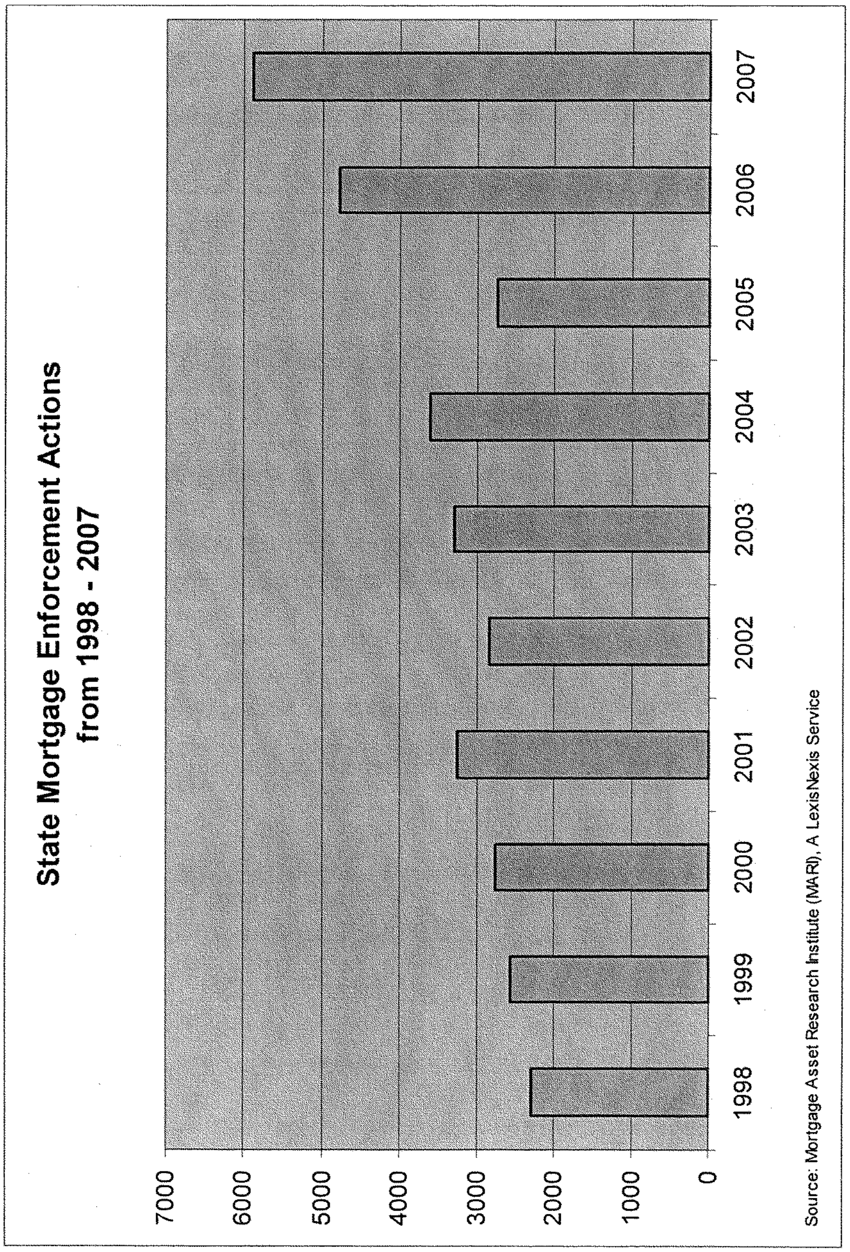
4. Encourage a diverse universe of financial institutions as a method of reducing risk to the system, encouraging competition, furthering innovation, insuring access to financial markets and promoting efficient allocation of credit.

5. Support community and regional banks, which provide relationship lending and fuel local economic development.

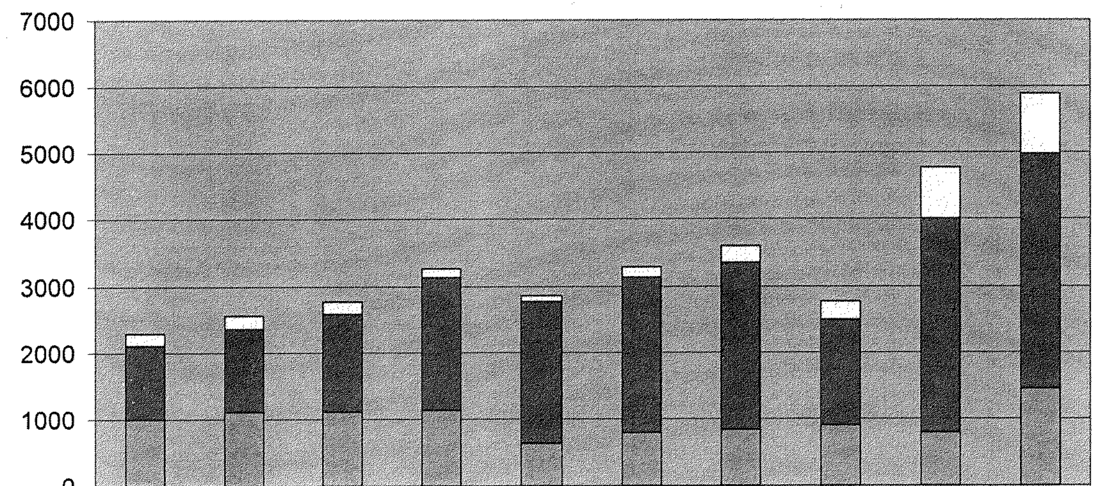
.6. Require financial institutions that are recipients of governmental assistance or pose systemic risk to be subject to safety and soundness and consumer protection oversight.

1/14/2009


State Mortgage Enforcement Actions
from 1998 - 2007
7000
6000
5000
4000
3000
2000
1000
0
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
Source: Mortgage Asset Research Institute (MARI), A LexisNexis Service


State Mortgage Enforcement Actions
from 1998 - 2007
7000
6000
5000
4000
3000
2000
1000
0
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
Source: Mortgage Asset Research Institute (MARI), A LexisNexis Service

State Mortgage Enforcement Actions from 1998 - 2007



	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
□ Disciplinary / Fines	185	212	180	133	93	171	249	260	761	912
■ Cease & Desist	1121	1242	1480	2002	2117	2343	2534	1595	3227	3527
▩ Criminal / Revocation	992	1116	1106	1126	638	782	829	904	788	1457

Source: Mortgage Asset Research Institute (MARI), A LexisNexis Service

DLLR
STATE OF MARYLAND
DEPARTMENT OF LABOR, LICENSING AND REGULATION

MARTIN O'MALLEY, Governor
ANTHONY G. BROWN, Lt. Governor
THOMAS E. PEREZ, Secretary

Office of the Commissioner of Financial Regulation
Sarah Bloom Raskin, Commissioner

www.dllr.state.md.us/finance
E-mail • finreg@dllr.state.md.us

February 13, 2009

Naomi Baum
Staff Director
Congressional Oversight Panel
732 North Capitol Street, NW
Rooms C-320 and C-617
Mailstop: COP
Washington, DC 20401

Dear Ms. Baum:

Thank you for the opportunity to participate in the Congressional Oversight Panel's hearing entitled "Modernizing America's Financial Regulatory Structure" on January 14, 2009.

I received the following Question for the Record from Mr. Damon Silvers:

> "Do you believe it would be possible to have a consumer protection regime in financial services with a federal floor and state ability to both enforce that floor and to set higher levels of consumer protection should states desire?"

I am pleased to provide the following response to be included in the official record of the hearing:

I believe that it is possible to have a consumer protection regime in financial services with a federal floor and state ability to enforce that floor and to set higher levels of consumer protection. I believe this regime already exists, in theory. Unfortunately, federal regulatory preemption of state consumer protection laws has inhibited states from setting higher levels of consumer protection standards that apply to all market participants. Therefore, I support the Congressional Oversight Panel's recommendation to eliminate federal preemption of the application of state consumer protection laws to national banks.

The traditional dynamic of the dual-banking system has been that the states experiment with new products, services, and practices that, upon successful implementation, Congress and/or federal regulatory agencies often later enact on a nationwide basis. The states have long been innovators in the area of consumer protection because we are often made aware of troubling practices, trends, or warning signs before the federal agencies can identify

Office of the Commissioner of Financial Regulation
500 North Calvert Street • Suite 402
Baltimore, Maryland 21202-3651

410-230-6100
(Toll Free) 1-888-784-0136
(Fax) 410-333-3866 / 410-333-0475

these emerging practices. The states can act to rectify individual consumer abuse, whereas the federal government, when it acts, usually waits for a concentration of abuses to emerge. From this perspective, state consumer protection is both nimble and precise.

There are many examples of state and federal coordination. State officials currently coordinate with the Federal Deposit Insurance Corporation, the Federal Reserve System, the Federal Trade Commission, the Financial Crimes Enforcement Network, and most recently, the U.S. Department of Housing and Urban Development. This cooperative federalism also provides effective safety and soundness supervision of financial entities, as well as consumer protection. Conflicts arise and cooperative federalism fails because of the preemptive policies of federal chartering agencies.

I believe that Congress needs to clarify that consumer protections apply equally to all market participants. State laws should not and cannot be preempted for a favored class of institutions. To preserve a responsive system, the states must be able to continue to innovate in consumer protections and regulation. The federal government would better serve our economies and consumers by fostering a new era of cooperative federalism.

Again, thank you for the opportunity to testify before the Congressional Oversight Panel and to respond to Mr. Silvers' excellent question.

Sincerely,

Sarah Bloom Raskin

Sarah Bloom Raskin
Maryland Commissioner of Financial Regulation

Professor WARREN. Thank you, Ms. Raskin. President Seligman.

STATEMENT OF JOEL SELIGMAN, PRESIDENT, UNIVERSITY OF ROCHESTER

Mr. SELIGMAN. Professor Warren, Members of the Panel, I'm delighted to join you.

There is today an urgent need for a fundamental restructuring of federal financial regulation, primarily based on three overlapping causes.

First, an ongoing economic emergency, initially rooted in the housing and credit markets, which has been succeeded by the collapse of several leading investment and commercial banks and insurance companies, dramatic deterioration of our stock market indices and now a rapidly-deepening recession.

Second, serious breakdowns in the enforcement and fraud deterrence missions of federal financial regulation, notably in recent months, as illustrated by matters involving Bear Stearns and the four then independent investment banks subject to the SEC's former Consolidated Supervised Entity Program, the government creation of conservatorships for Fannie Mae and Freddie Mac, the Bernie Madoff case, and, more generally, a significant decline in the number of prosecutions for securities fraud, at least in 2008.

Third, a misalignment between federal financial regulation and financial firms and intermediaries. The structure of financial regulation that was developed during the 1930s has simply not kept pace with fundamental changes in finance.

Against this backdrop, I would offer the following broad principles to guide consideration of a restructuring of federal financial regulation.

First, make a fundamental distinction between emergency rescue legislation which must be adopted under intense time pressure and the restructuring of our financial regulatory system which will be best done after systematic hearings and background reports.

Second, the scope of any systematic review of financial regulation should be comprehensive. This not only means that obvious areas of omission today, such as credit default swaps and hedge funds, need to be part of the analysis but also means, for example, our historic system of state insurance regulation should be re-examined as well as current securities laws exemptions for areas, including municipal securities.

A re-examination also is urgently needed of the adequacy of the current regulation of credit rating agencies and the scope of investment adviser exemptions. In a world in which financial holding companies can move resources internally with breathtaking speed, a partial system of federal regulation runs an unacceptable risk of failure.

The fact that the Federal Government provided over $100 billion to insurance giant AIG alone suggests that insurance regulation is no longer purely a state matter.

Third, Congress especially should focus on the structure of financial regulation rather than addressing specific standards at too great a level of granularity.

With respect to structure, I would propose consideration of a revitalized approach to federal financial regulation that, at the highest level, designates the Federal Reserve System as the apex or supervisory agency for all financial regulation with the expressed mission to address and minimize systemic risk. This is not a Twin Peaks model. This is more a holding company structure where the company must have comprehensive access to data and confidence in examinations to be able to address the problems of systematic risk which are not limited to any area.

Second, to preserve the expertise necessary to industry-specific regulation, I would nonetheless suggest consolidating industry-specific regulatory areas—agencies in areas such as banking and thrifts, securities and commodities, to preserve expert examination, inspection and enforcement roles.

Particular attention should be devoted to revitalizing enforcement, including the effective use of private rights of action and self-regulatory organizations to complement the role of the federal regulatory agencies.

And third, effectively allocate unregulated areas so that we eliminate today's regulatory holes.

Let me suggest in closing that there is a wise caution that a member of your panel suggested before. While I believe that any new system of federal financial regulation should be comprehensive, the fragility we have seen in global financial markets in recent months inevitably will reduce for a time willingness to rely solely on self-interests of the market to provide optimal behavior.

As SEC Chair Christopher Cox memorably wrote when the Commission disbanded the Consolidated Supervisory Entity Programs, "Voluntary regulation does not work."

The challenge in a new order will be also to avoid the tendency to over-regulate. Independent regulatory agencies, such as the SEC, have shown talent in customizing congressional enactments often enacted in times of crisis to achieve the best balance between investors and industries. That talent today also is urgently needed.

[The prepared statement of Mr. Seligman follows:]

TESTIMONY OF JOEL SELIGMAN

CONGRESSIONAL OVERSIGHT PANEL

THE CURRENT STATE OF THE FINANCIAL REGULATORY SYSTEM AND FUTURE REGULATORY RESTRUCTURING

JANUARY 14, 2009

ROOM 253, RUSSELL SENATE OFFICE BUILDING

Chairperson Warren, Congressman Hensarling, Senator Sununu, Mr. Neiman and Mr. Silvers, thank you for inviting me to testify today. My name is Joel Seligman. For the past 31 years I have been a professor whose research has addressed securities markets and financial regulation. I am here to offer my personal views. I am also the President of the University of Rochester and a member of the Board of Governors of FINRA. I am not speaking today on behalf of either of these organizations.

There is today an urgent need for a fundamental restructuring of federal financial regulation primarily based on three overlapping causes:

First, an ongoing economic emergency, initially rooted in our housing and credit markets, which has been succeeded by the collapse of several leading investment and commercial banks and insurance companies, dramatic deterioration of our stock market indices, and now a rapidly deepening recession.

Second, serious breakdowns in the enforcement and fraud deterrence missions of federal financial regulation, notably in recent months as illustrated by matters involving Bear Stearns and the other four then independent investment banks subject to the Securities and Exchange Commission's (SEC) former Consolidated Supervised Entities program,[1] the government

---

[1] See, e.g., Testimony of SEC Chair Christopher Cox, Reform of the Financial Regulatory System, House Comm. on Financial Services, 110th Cong., 2d Sess. (July 24, 2008) (describing creation of Consolidated Supervised Entities program); SEC Off. of Inspector Gen., SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program (Report No. 446-A Sept. 2008); SEC Chair Announces End of Consolidated Supervised Entities Program, SEC Press. Rel. 2008-230 (Sept. 26, 2008).

creation of conservatorships for Fannie Mae and Freddie Mac,[2] the Bernard Madoff case,[3] and more generally a significant decline in the number of prosecutions for securities fraud at least in 2008.[4]

Third, a misalignment between federal financial regulation and financial firms and intermediaries. The structure of financial regulation that was developed during the 1930s[5] has not kept pace with fundamental changes in finance:

- In the New Deal period, most finance was atomized into separate investment banking, commercial banking or insurance firms. Today finance is dominated by financial holding companies which operate in each of these and cognate areas such as commodities.

- In the New Deal period, the challenge of regulating finance was domestic. Now, when our credit markets are increasingly reliant on trades originating from abroad; our major financial institutions trade simultaneously throughout the world; and information technology has made international money transfers virtually instantaneous, the fundamental challenge is increasingly international.

- In 1930, approximately 1.5 percent of the American public directly owned stock on the New York Stock Exchange. A recent report estimates that in the first quarter of 2008 approximately 47 percent of U.S. households owned equities or bonds.[6] A dramatic deterioration in stock prices affects the retirement plans and sometimes the livelihood of millions of Americans.

- In the New Deal period, the choice of financial investments was largely limited to stocks, debt and bank accounts. Today we live in an age of complex derivative instruments, some of which recent experience has painfully shown are not well understood by investors and on some occasions by issuers or counterparties.[7]

---

[2] Federal Gov't Seizes Control of Fannie, Freddie Mac; GSEs Put in Conservatorship, 40 Sec. Reg. & L. Rep. (BNA) 1410 (2008).

[3] SEC Statement Regarding Madoff Investigation (Press Rel. 2008-297 (Dec. 16, 2008).

[4] See, e.g., Eric Lichtblau, Wall St. Fraud Prosecutions Fall Sharply, N.Y. Times, Dec. 25, 2008 at A1 (133 securities fraud prosecutions in the first 11 months of 2008 compared to 513 cases in 2002).

[5] See generally Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance chs. 1-7 (Aspen 3d ed. 2003).

[6] Investment Co. Inst. & Securities Indus. & Fin. Mrkts. Ass'n, Equity and Bond Ownership in America (2008).

[7] In November 2008, the President's Working Group announced a new policy to create central counterparts for OTC derivatives by year end. The same day the SEC, CFTC, and Federal Reserve System issued an MOU to implement the central counterparty concept. PWG,

- Most significantly, we have learned that our system of finance is more fragile than we earlier had believed. The web of interdependency that is the hallmark of sophisticated trading today means when a major firm such as Lehman Brothers is bankrupt, cascading impacts can have powerful effects on an entire economy.[8]

The size and scope of finance today is breathtaking. On September 1, 1929, the aggregate value of all securities listed on the New York Stock Exchange was approximately $90 billion.[9] At year end 2006, the total assets of the United States securities sector equaled $12.4 trillion, the banking sector had assets of $12.6 trillion, and the United States insurance industry held assets totaling $6 trillion.[10]

It is difficult to rationalize our current federal system of regulation that includes five separate federal depository institutions, specifically including the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration as well as state banking regulation in each state. We are one of the few countries that separately regulate securities and commodities. Securities regulation, like banking occurs both at the national and state level. Insurance regulation, in contrast, occurs solely at the state level.

Against this backdrop, I would offer the following broad principles to guide consideration of a restructuring of federal financial regulation:

First, make a fundamental distinction between emergency rescue legislation which must be adopted under intense time pressure and the restructuring of our financial regulatory order which will be best done after systematic hearings and background reports. This Panel already has well illustrated the risks associated with the creation and implementation of the Troubled Asset Relief Program.[11] A case can be made that the sense of crisis that preceded the enactment of the Economic Emergency Stabilization Act of 2008[12] justified moving with alacrity. But a fundamental restructuring of financial regulation should occur at a far more measured pace. The

---

Regulators Work to Encourage Launch of CDS Clearinghouse to End of December, 40 Sec. Reg. & L. Rep. (BNA) 1869 (2008).

8 Lehman Brothers Holdings Files Ch. 11 Petition after Gov't Denies Funding, 40 Sec. Reg. & L. Rep. (BNA) 1476 (2008). The next day, the Department of Treasury decided to orchestrate an $85 billion bailout for insurance giant, AIG, see ibid, and subsequently sought the $700 billion Economic Emergency Stabilization Act of 2008, ___Stat.___, 110th Cong., 2d Sess. (2008).

9 SELIGMAN, supra n.5, at 1.

10 Department of Treasury, Blueprint for a Modernized Regulatory Structure 165 (2008).

11 See, e.g., Accountability for the Troubled Asset Relief Program: The Second Report of the Congressional Oversight Panel (Jan. 9, 2009).

12 ___ Stat. ___, 110th Cong., 2d Sess. (2008)

creation of the Securities and Exchange Commission (SEC) and the adoption of the six federal securities laws between 1933 and 1940, for example, was preceded by the Stock Exchange Practices hearings of the Senate Banking Committee held between 1932 and 1934. The longevity of the federal regulatory system that Congress adopted in the New Deal period was a consequence of the thoughtfulness of these hearings and legislative and regulatory commission reports that preceded legislation. In the post-World War II period, after the late 1950s when the SEC was subject to harsh criticism for under-enforcement of the securities laws, the key to its subsequent successful revival was a combination of new leadership, a significant increase in its enforcement budget, and the 1961-1963 Special Study of the Securities Markets which framed the evolution of securities regulation for much of the next 20 years.[13]

Second, the scope of any systematic review of financial regulation should be comprehensive. This not only means that obvious areas of omission today such as credit default swaps[14] and hedge funds need to be part of the analysis, but it also means, for example, our historic system of state insurance regulation should be reexamined as well as current securities law exemptions for areas including municipal securities[15]. A reexamination also is urgently needed of the adequacy of the current regulation of credit rating agencies[16] and the scope of investment adviser exemptions. In a world in which financial holding companies can move resources internally with breathtaking speed, a partial system of federal oversight runs an unacceptable risk of failure. The fact that the federal government provided over $100 billion to insurance giant AIG alone suggests that insurance regulation is no longer purely a state matter.[17]

Third, Congress especially should focus on the structure of financial regulation, rather than addressing specific standards at too great a level of granularity. Historically Congress has had considerable success establishing regulatory agencies that address specific challenges subject to ongoing Congressional oversight. The creation of the Federal Reserve System and the SEC are two illustrations of this point. In contrast, it is often difficult given the crowded agenda of Congress to address specific problems with the detail and attention they deserve.

---

[13] See, e.g., SELIGMAN, supra n.5, chs. 9-10.

[14] SEC Chair Christopher Cox has proposed regulating the $58 trillion market for credit default swaps to address a "regulatory hole ... "completely lacking in transparency" that "is ripe for fraud and manipulation." SEC Chairman Urges Lawmakers to Confer Authority to Regulate Credit Default Swaps, 40 Sec. Reg. & L. Rep. (BNA) 1531 (2008).

[15] Pay-to-play practices have continued. See, e.g., Sisung Sec. Corp., Sec. Ex. Act Rel. 56,741, 91 SEC Dock. 2531 (2007).

[16] See, e.g, SEC Staff Examination of Select Credit Agencies, 2008 Fed. Sec. L. Rep. (CCH) 88,244 (2008) (criticizing credit agency examinations of residential mortgage-backed securities and collateralized debt obligations).

[17] Fed Again Invokes Emergency Powers with $37.8 Billion in New Loans to AIG, 40 Sec. Reg. & L. Rep. (BNA) 1643 (2008) (in addition to the provision of an earlier $85 billion).

Fourth, let me today address structure. I would propose consideration of a revitalized approach to federal financial regulation that:

(1) Designates the Federal Reserve System as the apex or supervisory agency for all financial regulation with an express mission to address and minimize systematic risk.

(2) Consolidates industry specific regulatory agencies in the areas of banking and thrifts, securities, and commodities to preserve expert examination, inspection, and enforcement roles. Particular attention here should be devoted to revitalizing enforcement including the effective use of private rights of action and self-regulatory organizations to complement the role of the federal regulatory agencies.

(3) Effectively allocates unregulated areas so that we eliminate today's regulatory holes.

Let me address each of these points in turn.

(1) The Federal Reserve Bank in recent years frequently has played a lead role in crisis management. This occurred after the October 1987 Stock Market Crash, the 1990s Asia, Russian and Long Term Capital crises, as well as the Stock Market Crash of 2008. The Fed's role, as with the role of the Department of Treasury, before the adoption of the Emergency Economic Stabilization Act of 2008, was typically ad hoc.

There is today a cogent case for the Federal Reserve System to serve as a crisis manager to address issues of systemic risk including those related to firm capital and liquidity. This has become all the more appropriate as financial firms increasingly are no longer just involved in securities or insurance or commodities or banking but can be involved in combinations that involve some or all of those product lines.[18]

But to transform the Federal Reserve Bank or, for that matter, the Department of Treasury, into the sole federal financial regulator, in my view, would be highly unwise.

The Federal Reserve System and the Department of Treasury do not focus on enforcement or fraud deterrence. The Fed and the Department of Treasury have multiple purposes, but a priority for each has been the safety and solvency of financial intermediaries, most notably commercial banks. As many have recognized,[19] there are "inherent conflicts that may arise from time to time between the objectives of safety and soundness and consume

---

[18] A caution here is appropriate. In response to the financial emergency we may see some dissolution of universal banks. See, e.g., David enrich, Citigroup Takes First Step toward Breakup, Wall St. J., Jan. 10-11, 2009, at A1.

[19] See, e.g., Group of Thirty, The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace (2008).

protection and transparency."[20] More specialized agencies such as the SEC, in contrast, have made fraud deterrence and the full disclosure system priorities with a particular mission of investor protection. While the SEC's recent performance today justifiably is subject to serious question, it should not be forgotten, that for much of its 75 year history, the Commission has been a leading independent regulatory agency because of its success in providing investors with confidence in its mandatory disclosure system. At its best, the Commission is the "cop on Wall Street." Even during a period when its performance has been quite question-begging, the SEC in Fiscal Year 2008, helped generate over $50 billion in settlements for injured investors and brought more than 670 cases that year, including 50 cases involving subprime lending.[21] More recently its work as the "investor's advocate" has been reflected in several significant settlements involving auction rate securities, including a very recent $30 billion settlement with Citigroup and UBS.[22]

It is improbable that a single super-federal financial regulator, regardless of its purposes, could systematically provide the same quality of enforcement and expertise than a structure that had a crisis manager at the apex of a structure and that also included specialized federal regulatory agencies such as the SEC and some of the depository institution regulatory agencies.

The broader an agency's jurisdiction the more likely it is to not have the resources or capability to address all appropriate priorities. A significant illustration of this involved the SEC itself during the late 1990s. Given an inadequate budget, Commission ongoing review of periodic disclosure documents such as Form 10-K badly deteriorated. In October 2002, a staff report of the Senate Governmental Affairs Committee, for example, found that in FY 2001 the SEC's Division of Corporate Finance was able to complete a full review of only 2280 of 14,600 Form 10-K annual reports, roughly 16 percent, far short of the Division's stated goal to review every company's annual report at least once every three years. "Of more than 17,300 public companies, approximately 9200 or 53%, have not had their Form 10-Ks reviewed in the past three years." Enron, then the most notorious example of staff neglect, had last received a partial review of its Form 10-K annual report in 1997 and had been last subject to a full review in 1991.[23] The argument can be made that had the SEC had the resources to have run the Division of Corporate Finance at more appropriate levels, the Public Company Accounting Oversight Board might not have been needed.

The creation of the PCAOB, however, ensured that there would be one federal agency solely responsible for audit quality. The Board, unlike the SEC of 1990s, had a narrow agenda and did not have to balance using resources for audit review with a broad array of other potential

---

20 Id. at 10.

21 SEC, 2008 Performance and Accountability Report at 2-3.

22 See, e.g, Citigroup, UBS Agree to Pay Record $30 Billion in ARS Settlement, 40 Sec. Reg. & L. Rep. (BNA) 2049 (2008).

23 II Staff Report to Senate Comm. on Gov't Affairs, Financial Oversight of Enron: The SEC and Private Sector Watchdogs 13, 31-32 (Oct. 8, 2002).

priorities such as market regulation, broker-dealer and investment adviser regulation, new securities offerings, municipal and governmental securities dealers, and enforcement. While the first SEC Chair, Joseph Kennedy, memorably observed in 1935 that "I'd hate to go out of here thinking that I had just made some changes in accounting practices,"[24] it is reasonable to assume that no one at the PCAOB has ever derogated improving audit quality.

There are pivotal advantages to having expert, well focused agencies. In emergency circumstances such as those of last July or September, the SEC was able to invoke its powers under Section 12(k)(2) of the Securities Exchange Act to adopt orders that addressed naked short sales very rapidly with considerable precision in designing the rule give the agency's understanding of the securities markets.[25]

The challenge is to find the right balance between expertise, which is a byproduct of a well run regulatory agency, and effectiveness, which often can be better achieved by reducing the number of responsible agencies and increasing resources for each. There is no algebraic formula to achieve this balance. Too little weight, in my view, was accorded to agency expertise in the Treasury Department's Blueprint for a Modernized Financial Regulatory Structure[26] and there is a need for detailed hearings in the near term future not only to examine what went wrong but also to examine what existing financial regulatory agencies do well and what the costs of restructuring will be.

(2) A pivotal criterion to addressing the right balance in designing a regulatory system is one that reduces as much as is feasible regulatory arbitrage. Whatever the historical reasons for the existence of a separate SEC and Commodities Futures Trading Commission (CFTC), the costs of having a system where in borderline cases those subject to regulation may choose their regulator is difficult to justify.[27] In too many instances such as those involving OTC derivatives, ambiguity with respect to responsibility has led to a system that too often has ignored or under-regulated pivotal aspects of our economy. Similarly, a disadvantage of a federal financial regulatory system with five depository institution regulatory agencies as well as the opportunity for banks or thrifts to solely choose state regulation undermines the ability to create and enforcement appropriate standards.

The design of an appropriate regulatory structure should take into account several fundamental questions which also will include identification of the purposes or objectives of each agency, their jurisdiction or scope, their political structure, enforcement and other powers,

---

[24] Seligman, supra n.5, at 116-117.

[25] See, e.g,. Sec. Ex. Act Rel. 58,572, ___ SEC Dock. ___ (2008),

[26] DEPARTMENT OF TREASURY, supra n.10.

[27] Cf. Testimony of Joel Seligman, House Comm. on Fin. Serv., Regulatory Restructuring and Reform of the Financial System (Oct. 21, 2008) (addressing political challenges of consolidating the SEC and CFTC). Among others, the Department of Treasury has supported this consolidation. DEPARTMENT OF TREASURY, supra n.10, at 11-13, 106-126.

and coordination with international regulatory norms. Each of these topics deserves thoughtful consideration.

Until quite recently, for example, it was assumed that proposals to consolidate regulatory agencies would be accompanied by calls for broader exemptions for smaller firms, as was proposed by a 2006 SEC Advisory Committee[28] or proposals to restrict private litigation as were made by several recent proponents.[29] A frequently expressed theme involves replacing detailed financial regulation with more principles-based regulation.[30]

Indeed a leitmotiv of the Treasury Department Blueprint was its strong preference for "core principles" rather than detailed legal standards. Core principles are an inspiring aspiration. All of us would like to make regulation simpler and more efficient. There is no more serious question that in some instances regulatory rules are historical artifacts or have grown longer and more expensive in terms of compliance costs than is wise. But that said, core principles are only part of what a mature regulatory system requires. For example, the Treasury Department repeatedly praised the Commodity Future Modernization Act Core Principles. These include:

> 3) Contracts not readily subject to manipulation – The board of trade shall list on the contract market only contracts that not readily subject to manipulation.
>
> 17) Recordkeeping – The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the Commission for a period of 5 years.[31]

While these core principles may be helpful, they cannot stand alone without an enabling statute, often detailed regulation, case law, and agency interpretative guidance. What, for example, is manipulation? It is not a self-defining term. What records must be retained? What form and manner will be acceptable to the Commission?

There are sometimes quite negative consequences of an overemphasis on core principles. To the extent that this may result in ambiguity in legal requirements, core principles may inspire greater litigation. The history of the SEC in areas such as the net capital rule suggests that without detail and customizing by type of transaction a principle or rule itself can be undermined

---

28 SEC Advisory Committee on Smaller Public Companies, 87 SEC Dock. 1138 (2006)

29 See, e.g., Interim Report of the Comm. on Capital Market Regulation (Nov. 30, 2006).

30 See, e.g., Financial Services Roundtable, Blueprint for U.S. Financial Competitiveness (2007).

31 DEPARTMENT OF TREASURY, supra n.10, at 215-218.

by unexpected SRO or industry initiatives as was done in the late 1960s during the so-called back office crisis.[32]

I would urge a separate significant caution with respect to ongoing initiatives to substitute international standards in areas such as accounting for existing United States standards.[33] As Financial Accounting Standards Board Chair Bob Herz has aptly stated: "We have the best reporting system, but the rest of the world will not accept it."[34] We also have the largest proportion of individual investors. Internationalization of accounting standards, if done unwisely, potentially could significantly weaken our system of investor protection.

To make this point in other terms, creation of a single crisis manager at the apex of our financial regulators only begins analysis of what an appropriate structure for federal financial regulation should be. Subsequently there would need to be considerable thought given as to how best to harmonize these new risk management powers with the roles of those specialized financial regulatory agencies that continue to exist.

Existing federal financial regulatory agencies often have quite different purposes and scopes. Bank regulation, for example, has long been based on safety and solvency priorities; securities regulation largely focuses on investor protection. The scope of banking regulation addresses, among many other topics, consumer protection. Securities laws address full disclosure, accounting standards, audit quality, broker-dealer and investment adviser regulation, regulation of stock exchanges and fraud enforcement, among many other topics. Insurance and commodities regulation have similar distinctive purposes and scope.

These differences in purpose and scope, in turn, are often based on the quite different pattern of investors (retail versus institutional, for example), different degree of internationalization, and different risk of intermediation in specific financial industries.

The political structure of our existing agencies also is strikingly different. The Department of Treasury is part of the Executive Branch. The Federal Reserve System and Securities Exchange Commission, in contrast, are meant to be independent regulatory agencies. Independence, however, as a practical reality, is quite different at the Federal Reserve System, which is self-funding, than at the SEC and most independent federal regulatory agencies, whose

---

[32] Seligman, supra n.5, at 457-458 (describing different approaches to net capital at the New York Stock Exchange and the SEC and how then NYSE Rule 325 permitted withdrawal of capital during a shorter period of time than SEC Rule 15c3-1).

[33] The Securities and Exchange Commission has proposed a roadmap for potential use of financial statements prepared in accordance with international financial reporting standards by United States issuers. See Sec. Act. Rel. 8982, ___ SEC Dock. ___ (2008); see also Sec. Act Rel. 8831, ___ SEC Dock. ____ (2008) (related concept release). This initiative has drawn strong criticism. See, e.g., Remarks of PCAOB Board Member Charles Niemeir, 2008 Sarbanes-Oxley, SEC and PCAOB Conference, N.Y. State Soc'y of CPAs, N.Y. City (Sept. 10, 2008)

[34] Herz quoted in NIEMEIR, supra n.33.

budgets are presented as part of the administration's budgets. In creating the SEC and most independent regulatory agencies, Congress did stress the need to depoliticize leadership by requiring that "[n]o more than three of such commissioners shall be members of the same political party..."

With respect to the SEC, as in the past, there is today a particular need for a combination of new leadership, a budget better aligned with its mission and legislation that specifically addresses regulatory gaps that are no longer acceptable. President-elect Obama has wisely selected a talented and experienced new Chair in Mary Schapiro and emphasized his personal interest in prioritizing the restructuring of financial regulation. These are critical initial steps. Over time, the Commission, working with Congress, will want to address a number of specific topics such as better harmonizing broker-dealer and investment adviser regulation and reviewing its ethics rules to obviate the appearance or reality that service at the Commission involves a revolving door with industry.

(3) I have urged that any new system of federal financial regulation should be comprehensive. A final caution is in order. The fragility we have seen in global financial markets in recent months inevitably will reduce for a time willingness to rely solely on self-interest or the markets to provide optimal behavior. As SEC Chair Christopher Cox memorably wrote when the Commission disbanded the Consolidated Supervisory Entities program that previously had regulated the five largest independent investment banks, "voluntary regulation does not work."[35] The challenge in a new order will be to avoid the tendency to over-regulate. Independent regulatory agencies such as the SEC often have shown talent in customizing Congressional enactments, often adopted in times of crisis, to achieve the best balance between investors and industry. That talent too is urgently needed today.

---

[35] SEC Press-Rel. 2008-230 (Sept. 26, 2008).

Professor WARREN. Thank you, President Seligman. Dr. Shiller.

STATEMENT OF DR. ROBERT SHILLER, ARTHUR M. OKUN PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Dr. SHILLER. I have written two books about what we should do in this crisis. One of them called Subprime Solution came out in September and one of them with George Akerlof called Animal Spirits will come out next month.

I cannot summarize all of the things I said in those books, but basic point, I think that we need to democratize finance and we need to develop new financial institutions. This is a time when we have to have the spirit of the New Deal about us, that we are going to create something that will bring us into the 21st Century.

In my brief remarks, the point is that we have to go for specific ideas, not just rearranging the regulators. It's not about saying no, it's about coming up with something new. So I want to give some examples of new ideas.

One of them is from the Squam Lake Working Group which advises academics. It goes back to an idea of Mark Flannery, and the idea is that firms or banks particularly should be encouraged to issue a new kind of debt which we call regulatory convertible debt. Regulators get involved in telling companies they can issue this debt and it will count as capital. It will convert to equity if a trigger is reached which could be merely that the regulator decides that we're in a financial crisis or it could be based on some objective trigger.

But the point is that the capital that banks have would be automatically increased by converting debt to equity at a time of crisis. This is very different than having TARP come in with public money and contribute it to capital at a time of crisis and it would prevent the kind of—this is really central because it would prevent the kind of downward spiral that created the crisis we're in. This is financial innovation that works at the fundamental problem of systemic vulnerability.

Now some other ideas. One is from my book. We ought to—the government ought to be subsidizing personal financial advice. This is expensive, but it is important. The crisis was substantially due to errors that people made and I would track that back to the fact that they were not getting advice.

The cheap thing to do is financial education. That can be really cheap. All we have to do is think of a curriculum and put it on the Web, but that doesn't work for many people. They cannot read the complicated brochures alone. They need someone to help them.

Third idea. It's really yours, Elizabeth. The idea of a financial products safety commission. I'll let you explain that, but I think, once again, it is about democratizing finance, about having someone representing the individual.

Fourth point. I think the real fundamental problem which underlies this crisis is a failure of risk management and so instead of saying no to new financial derivatives, we have to make them work better for everyone and I think that means expanding the scope of our financial markets. Notably, real estate is a risk which is underlying this crisis and is not hedgeable, it's not manageable, and the kinds of securities that we've developed to manage such risks entail unfortunate counterparty risk and systemic risk. So we have to think about how to make it possible for a broader array of risks to be managed.

Finally, I talk about in my Subprime Solution book a new mortgage institution that we could create which would be helpful in managing the risks of families. I call it a continuous work-out mortgage.

This would be a mortgage that would automatically adjust the payment the way a work-out does in response to objective factors, continuously and automatically. That is, for example, if we fall into a recession or we see a big drop in home prices, there would be a formula written into a mortgage contract that would automatically adjust down the payment and the principal.

If we had had such a thing in place today, it would have prevented a lot of economic suffering. Instead of having families go through months or years of difficulty in paying their mortgage and then running out of money and going in begging for help, we would have had them helped automatically. These are the kinds of ideas that I think we have to think about. It's ideas that are innovations and that represent creative new solutions to the problems that we've seen.

[The prepared statement of Dr. Shiller follows:]

Testimony of Robert J. Shiller

Arthur M. Okun Professor of Economics and Professor of Finance, Yale University
Research Associate, National Bureau of Economic Research
Co-founder and Chief Economist, MacroMarkets LLC

Submitted to the Congressional Oversight Panel
January 14, 2009

Madame. Chair and members of the Panel, I thank you for the opportunity to testify today. My name is Robert J. Shiller, and I am Professor of Economics and Finance at Yale University, author of the books about the current crisis *Subprime Solution*, 2008 and (with George Akerlof) *Animal Spirits*, 2009, Research Associate, National Bureau of Economic Research, and Co-founder and Chief Economist, MacroMarkets LLC.

The Congressional Oversight Panel has an important mission, for it is in charge of evaluating Treasury's spending of up to $700 billion in the Troubled Asset Relief Program (TARP). That amount is $2300 for every adult and child in the country, and the citizens have the right to demand that this money, taken from them and spent on their behalf, is spent wisely.

The Treasury could easily squander the money. One difficulty is that the purpose of the TARP, preventing economic collapse, is challenging in many respects. Success depends on restoring a credit system that has come under great strain because of unanticipated system-wide problems, and restoring confidence.

The chief criticism of the spending of this money to date is that it has been *ad hoc*, and after-the-fact, and apparently devoid of any obvious principles. Treasury has been accused of dispensing goodies to large firms who have political muscle, and ignoring systematic allocation. They are accused of encouraging firms to rely as much as possible on government handouts, and to play games to receive such handouts. Such problems may be inevitable as we struggle to deal with a serious ongoing crisis, but we should get past them as quickly as possible.

Correcting this means that as soon as possible the interventions we have seen today should be replaced by or aligned with long-term systematic structures that are as market-oriented and apolitical as possible.

In its first report the Congressional Oversight Panel posed ten questions. Let us look at some of them here:

Is the strategy working to stabilize markets?"

"Is the strategy working to reduce foreclosures?"

"What have the financial institutions done with the taxpayers' money disbursed so far?"

I would also offer some slightly different questions:

"Is the strategy working to improve the functioning of markets to allocate risk and resources?"

"Is the strategy working to deal with foreclosures in the interest of all parties, including those who invest in mortgage securities and those who would borrow with mortgages in the future?"

"Does the financial institutions' use of the money disbursed so far indicate that they are functioning better as conduits of information and providers of intermediation services ?"

Answering such questions means addressing the allocative and incentive effects of structures that are set up to deal with the crisis. And answering such questions best takes the form of proposing specific procedures or institutions that deal with financial crises by making the responses systematic.

I want to discuss some such ideas today that are not just my own, but that have been hashed out recently by the Squam Lake Working Group, of which I am a member. This group is non-affiliated, and genuinely non-partisan, of academics who first convened at Squam Lake New Hampshire in November 14-15, 2008 and have been meeting since to come up with a method of dealing with the current U.S. financial crisis.

In my opinion, this group has particular authority in this financial crisis because of their expertise in the area of creating the proper risk management and incentive environment. They are expert in exactly the issues that informed criticism of TARP has been focused.

The problem we are facing, and which motivates much of the actions of the Troubled Asset Relief Program (TARP) is that banks, and related financial institutions, are in trouble: they do not have enough capital to lend, and so have been sharply curtailing their discretionary lending activity and support of securitization of credit instruments.

But, as modern financial theory reveals, and as described in a classic paper by Prof. Stuart Myers at the Massachusetts Institute of Technology, a "debt overhang problem" may inhibit banks' raising more capital at a time of financial crisis. When debt looms large relative to financial outlook, new providers of capital may not have an incentive to come forth because they know that a large part of the return of their investment will go just to paying off the banks debts. Hence, at a time of a systemic financial crisis, relatively little capital is provided, and, unless there is government intervention, the firms will try to restore their capital ratios by dumping their assets on the market to restore capital ratios, rather than by raising more capital. Fire sales of troubled assets occur. Though banks did raise equity in response to reported losses in the recent crisis, there is concern that banks may not do so adequately in extreme events, and that they may under-report losses to avoid raising additional equity.

The banks do not have an incentive to raise new capital. Instead, they become vulnerable, and, unless they are helped, would tend to fall into bankruptcy. Moreover, banks have little prospect of emerging as functioning organizations once they enter bankruptcy, because of the complexity of their interrelations with others. Thus, a rash of bank shutdowns threatens the lifeblood of the system.

The TARP was initially planned to buy the troubled assets, preventing their fire sales from depressing the market too much. In fact, the TARP became involved with supplying capital to the banks from the government when private suppliers were not around. These measures, while useful in the emergency situation we have been facing, are not ideal. The Treasury cannot, despite its good intentions, allocate capital the way a broad marketplace can.

The Squam Lake Group has considered a number of other ways to deal with this fundamental problem.

Notably, they have recommended that if banks issue a new form of debt that they have named "regulatory convertible debt" these securities would count as bank capital. This new kind of debt automatically converts to equity at a trigger based on systemic as well as individual bank parameters, or at the discretion of regulators during a financial crisis. It would have the regulatory capital advantages of equity and the tax advantages to corporations that debt has, until it is converted, but would serve a different function in a crisis by bolstering capital.

By encouraging banks to issue a good share of their debt in this form, regulation could insure that there is a smooth transition-with fewer systemic ill-effects, of the next banking crisis.

There may be other ways to achieve much the same end, which is to install a macroprudential regulation that is countercyclical and that results in capital requirement loosenings, rather than tightenings, in times of stress. We do not have such regulation in place today, and so we remain in a difficult situation which TARP has been trying to deal with in the best way possible.

Taking steps towards long-term solutions does, however, help the immediate problem, for it helps restore confidence and trust in our system, and encourages people to think that we are moving to a better and stronger economic system, rather than a patchwork one.

The panel can best fulfill its mission by reporting to Congress on regulatory changes, like regulatory convertible debt, that will make for a free-market system of finance that will make the measures taken to date by Treasury unnecessary in the future.

References:

Congressional Oversight Panel, "Questions about the $700 Billion Emergency Economic Stabilization Funds" December 10, 2008

Congressional Oversight Panel, "Accountability for the Troubled Asset Relief Program," January 6, 2009.

Myers, Stuart C., "Determinants of Corporate Borrowing," *Review of Financial Studies*, 5:147-75, 1977.

The Squam Lake Working Group on Financial Regulation, "Expedited Resolution Mechanisms for Distressed Financial Firms," January 2009, www.SquamLakeWorkingGroup.org

Professor WARREN. Thank you, Dr. Shiller. Two books, five minutes.

Dr. Stiglitz.

STATEMENT OF JOSEPH E. STIGLITZ, PH.D., UNIVERSITY PROFESSOR, COLUMBIA BUSINESS SCHOOL

Dr. STIGLITZ. Thank you for holding these hearings.

I feel quite strongly that part of the reason that our financial system has performed so poorly is inadequate regulation and regulatory structures. There's a lack of confidence in our financial system which is well earned, but how can there be restoration of confidence when all we have done is to pour more money into the banks? We have changed neither the regulatory structures, the incentive systems, nor even those who are running these institutions.

While everyone talks of the need for better regulation, the devil is in the details. Some have pushed for cosmetic reforms instead of the real reforms that we need. Those who engage in deceptive financial practices will push for deceptive regulatory reform.

It is hard to have a well-functioning modern economy without a sound financial system. However, financial markets, as has already been said, are not an end in themselves but a means. They are supposed to mobilize savings, allocate capital, and manage risk, transferring it from those less able to bear it to those more able.

By contrast, our financial markets have encouraged excessive consumption and have misallocated capital. Instead of managing risk, they created it. These problems have occurred repeatedly and are pervasive. This is only the latest and biggest of our bail-outs, each of which reflects a failure of our financial system to fulfill its basic functions, including ascertaining creditworthiness.

The problems are systemic and systematic. These failures are in turn related to three more fundamental problems. Markets only work well when there are well-designed incentives, a high level of transparency, and effective competition. America's financial markets fail on all accounts.

Markets only work well when private returns are aligned with social returns. Incentives matter, but when incentives are distorted, we get distorted behavior. Our banks have incentives designed to encourage excessive risk-taking and short-sighted behavior. Lack of transparency is pervasive in financial markets and is in part the result of flawed incentive structures. Indeed, those in the financial markets have resisted improvements, such as more transparent disclosure of the cost of stock options. This provided incentives for bad accounting.

Failure to enforce strong competition laws results in institutions that are so large they are too big to fail and almost too big to be bailed out. That provides an incentive to engage in excessively risky practices.

When financial markets fail, as they have done, the costs are enormous. There are, as economists put it, severe externalities. The losses include not only the budgetary costs in the hundreds of billions of dollars but also costs to the entire economy, totaling in the trillions, before we have fully recovered. The damage to our standing in the world is inestimable.

Good regulation can increase the confidence of investors in markets and serve to attract capital to financial markets. It can also encourage real innovation. Much of our financial market's creativity was directed to circumventing regulations, taxes, and accounting standards. Accounting was so creative that no one, not even the banks, knew their financial position.

Meanwhile, the financial system didn't make the innovations which would have addressed the real risks people face, such as how to stay in their homes when interest rates changed or economic conditions changed. Professor Shiller has shown how it's easy to come up with innovations of this kind. Not only did they not do this, but they also resisted these kinds of innovations.

In short, regulations can help markets work better. We need regulations to ensure the safety and soundness of individual financial institutions and the financial system as a whole to protect consumers, maintain competition, ensure access to finance for all, and maintain overall economic stability. They need to focus both on practices and products.

It has been commonplace to emphasize the need for more transparency, which is why any retreat from mark to market would be a mistake, but we should realize that lack of transparency is a symptom of deeper problems. Even if transparency issues were fully addressed, much more needs to be done.

For instance, even if there were full transparency, some of the products the financial markets created were so complex that not even their creators fully understood their risk properties. We have to ensure that incentive structures do not encourage excessively-risky short-sighted behavior. We need to reduce the scope of conflicts of interest which are rife within the financial system. Securitization, for all the virtues of diversification, has introduced new asymmetries in information, forcing originators of mortgages to bear some of the risk and mitigate some of the resulting moral hazard.

Derivatives and similar financial products should neither be purchased nor produced by banks, unless they have been approved for specific uses by a financial products safety commission and unless their use conforms to the guidelines established. They should be instruments for laying off risk, not instruments for gambling. Regulators should encourage the move to standardized products; greater reliance on standardized products, rather than tailor-made products, may increase both transparency and efficiency of the economy.

Professor WARREN. Dr. Stiglitz, can I ask you to wrap up your opening remarks?

Dr. STIGLITZ. Okay. There are a large number of other reforms that I talk about in my written testimony.

Let me just conclude by saying TARP has failed partly because of the failure to do anything about regulation. We need to impose conditionality on the use of the funds if we are to have any confidence that the next tranche of funds have better outcomes than the last tranche of funds.

We need, as Professor Shiller pointed out, to encourage more innovation. One way of thinking about this is if we had taken $700 billion and created a new institution which had used a normal leverage of 10:1, we could have created a flow of credit of $7 trillion. We would have done far better if we had started fresh, rather than bailing out the failed institutions of the past.

Now, no one has proposed that, but the point I wanted to make is that we are putting an awful lot of money in the system. We have had repeated bail-outs, not just the S&L bail-out, but also the Mexican, Indonesian, and Korean bail-outs of the financial markets. These were not bail-outs of the countries: They represent failed lending practices of our financial institutions.

Unless we impose better, smarter regulation, we will have another one of these encounters in a short period of time.

[The prepared statement of Dr. Stiglitz follows:]

Testimony before the Congressional Oversight Panel
Regulatory Reform Hearing
January 14, 2009

by Joseph E. Stiglitz

First, let me thank you for holding these hearings. The subject could not be more timely. Our financial system has failed us. A well-functioning financial system is essential for a well-functioning economy. Our financial system has not functioned well, and we are all bearing the consequences. Millions are losing their homes, along with their life savings and their dreams for their future and the future of their children. Many who worked hard for a lifetime and had looked forward to retirement with a modicum of comfort face the remaining days of their lives with hardship and uncertainty. Many will not be able to send their children to college. Millions will lose their jobs as the economy goes deeper into recession. Every month it is clear that our downturn is deepening.

The failure to act quickly and effectively means that the downturn will be longer and deeper than it otherwise would have been, and we will emerge from the crisis with a larger legacy of debt, less able to meet any contingency which our country faces. That is why it is imperative that we design a stimulus package with the biggest bang for the buck and which leaves the nation's balance sheet in the best position possible. Household tax cuts, except for the poorest, have no place in such a program. Neither do loss carry-backs, except when closely linked with investment. The one tax cut that should be included is a temporary incremental investment tax credit; it provides a big bang for the buck, encouraging firms to undertake investment *today*, when the economy needs the spending. The most immediate need is relief to states, without which we will see further cutbacks in employment and basic services; but beyond that, we need increased investments in education and technology as well as infrastructure, help to the unemployed, and a plan to address foreclosures.

My subject today, however, is not the stimulus but regulatory reform, the failed bail-outs of the banks, and what should be done going forward.

REGULATORY REFORM

Part of the reason that our financial system has performed so poorly is inadequate regulation and regulatory structures. Some have argued that we should wait to address these problems: we have a boat with holes, and we must first fix those holes. But we know the boat has a faulty steering mechanism and is being steered by captains who do not know who to steer, least of all in these stormy waters. Unless we fix both, there is a risk that the boat will go crashing on some other rocky shoals before reaching port. The time to fix the regulatory problems is now.

Part of the problem today is a lack of confidence in our financial system. But how can there be a restoration of confidence when all we have done is to pour more money into the banks? We have changed neither the regulatory structures, the incentive systems, nor even those who are running these institutions. As we taxpayers are pouring money into these banks, we have even allowed them to pour out money to their shareholders and to their executives in the form of bonuses, and to acquire other institutions. We imposed no conditions that would lead to more lending, and not surprisingly, we have not gotten more lending. At a time of increasing concern with mounting national debt, we provided the banks funds in a way which makes it unlikely that we will get a fair return, adjusted for risk, on the money provided.

This morning I want to describe briefly the principles, objectives, and instruments of a 21st century regulatory structure.

Some General Principles

It is hard to have a well-performing modern economy without a good financial system. However, financial markets are not an end in themselves but a means: they are supposed to mobilize savings, allocate capital, and manage risk, transferring it from those less able to bear it to those more able. Our financial markets have not performed these functions well: they encouraged spendthrift patterns, which led to near-zero savings; they misallocated capital; and instead of managing risk, they created it, leaving huge risks with ordinary Americans who are now bearing huge costs because of these failures.

These problems have occurred repeatedly and are pervasive. This is only the latest and biggest of the bail-outs that have become a regular feature of our peculiar kind of capitalism. The S & L bail-out cost American taxpayers several hundred billions of dollars; but we should remember that the Mexican, Indonesian, Korean, Brazilian, Russian, and Argentinean bail-outs were all bail-outs of Wall Street. They were as much a bail-out of the countries whose name they bear as the sub-prime bail-out is a bail-out of poor Americans. All of these reflect a failure of our financial system to fulfill its most basic function, ascertaining credit worthiness. The problems are systemic and systematic.

These failures are, in turn, related to three more fundamental problems. Markets only work well when there are well designed incentives, a high level of transparency, and effective competition. America's financial markets failed on all accounts.

Incentives. Markets only work well when private rewards are aligned with social returns. Incentives matter, but when incentives are distorted, we get distorted behavior. In spite of their failure to perform their key social functions, financial markets have garnered for themselves 30% or more of corporate profits—not to mention the huge compensation received by their executives. But the problem with incentive structures is not just the level but also the form—designed to encourage excessive risk taking and short-sighted behavior.

Transparency. The success of a market economy requires not just good incentive systems but good information—transparency. Markets fail to produce efficient outcomes when information is imperfect or asymmetric. They put liabilities off-balance sheet, making it difficult to assess accurately their net worth. They created over the counter derivatives which were so complex that the banks can't even assess their own balance sheets. They know that accordingly there is no way that they can know the balance sheet of other banks. This non-transparency is a key part of the credit crisis. Lack of transparency is pervasive in financial markets and is in part the result of flawed incentive structures. Indeed, those in financial markets have resisted improvements, such as more transparent disclosure of the costs of stock options, which provided incentives for bad accounting:

Competition. Competition is a third element of well-functioning markets. There are a number of institutions that are so large that they are too big too fail. That provided an incentive to engage in excessively risky practices. It was a heads I win—they walk off with the profit—tails you lose—we, the taxpayers, assume the losses. This non-transparency is a key part of the credit crisis that we have experienced over recent weeks.

What is clear is that financial markets with inadequate government regulation failed on each of these three counts. When financial markets succeed, they bring benefits to our entire economy, but when they fail, as they have now done, the costs are enormous. There are, as economists put it, severe externalities. The losses include not only the direct budgetary costs, in the hundreds of billions of dollars, but also costs to our entire economy, totaling in the trillions before we have fully recovered. The damage to our standing in the world is inestimable.

Well-functioning markets require a balance between government and markets. Markets often fail, and financial markets have, as we have seen, failed in ways that have large systemic consequences. The deregulatory philosophy that has prevailed in many Western countries during the past quarter century has no grounding in economic theory or historical experience; quite the contrary, modern economic theory explains why the government must take an active role, especially in regulating financial markets.

Good regulation can increase confidence of investors in markets and thus serve to attract capital to financial markets. Critics of regulation worry that it will stifle innovation. On the contrary, well designed regulations encourage *real* innovation. Much of our financial market's creativity was directed to circumventing regulations, taxes, and accounting standards; as we have noted, the accounting was so creative that no one, not even the banks, knew their financial position. Meanwhile, the financial system didn't make the innovations which would have addressed the real risks people face—such as how to stay in their homes when interest rates change—and indeed, have resisted many of the innovations which would have increased the efficiency of our economy. By reducing the scope for these socially unproductive innovations, we can divert creative activity to more productive directions.

Regulations can help markets work better. We need regulations to: (a) ensure the safety and soundness of individual financial institutions and the financial system as a whole; (b) protect consumers; (c) maintain competition; (d) ensure access to finance for all; and (d) maintain overall economic stability. In my remarks this morning, I want to focus on the outlines of a regulatory structure focusing on safety and soundness of our institutions and the systemic stability of our system. But we should note that some of the worst practices—imposing the greatest risk on our financial system—have involved predatory lending, taking advantage of some of the poorest members of our society.

Regulations need to focus both on practices and products. It has been commonplace to emphasize the need for more transparency, which is why any retreat from mark-to-market would be a mistake. But we should realize that lack of transparency is a symptom of deeper problems; even if transparency initiatives were fully effective, much more needs to be done. Too often, a focus on transparency represents an attempt to divert discussion from these more fundamental reforms, which I outline in greater detail below.

For instance, we have to ensure that incentive structures do not encourage excessively risky short sighted behavior; we need to reduce the scope of conflicts of interest—our financial markets are rife with them. Securitization, for all the virtues in diversification, has introduced new asymmetries of information; forcing originators of mortgages to bear some of the risk would mitigate some of the resulting moral hazard.

Derivatives and similar financial products should neither be purchased nor produced by highly regulated financial entities, unless they have been approved for specific uses by a financial products safety commission (FPSC, discussed below) and unless their use conforms to the guidelines established by the FPSC. They should be instruments for laying off risk, not instruments for gambling. Regulators should encourage the move to standardized products. Greater reliance on standardized products rather than tailor-made products may increase transparency and the efficiency of the economy. It reduces the information burden on market participants, and it enhances competition (differentiating products is one of the ways that firms work to reduce the force of competition). (These restrictions would both reduce exposure to excessive risk, including counterparty risk, and increase transparency.)

We need countercyclical capital adequacy/provisioning requirements and speed limits. Well-designed countercyclical capital adequacy regulations would mitigate some of the problems raised by mark-to-market. We need to proscribe excessively risky and exploitive lending (predatory lending)—many of our problems are a result of lending that was both exploitive and risky.

We need a Financial Products Safety Commission to make sure that the products purchased by an individual, a bank or pension fund are "safe" and appropriate, designed to manage the risks they face.

Regulation needs to be comprehensive—both across institutions and across countries. Otherwise there will be regulatory arbitrage. Funds will, for instance, flow through the least regulated or least transparent part. Transparency requirements on part of the system may help ensure the safety and soundness of that part of the system but will provide little information about systemic risks. This has become particularly important as different institutions have begun to perform similar functions.

But regulation will never by fully comprehensive, so we need especially to regulate large, systemically important institutions and highly leveraged institutions—the kinds of institutions which pose a threat to our economy. But we must recognize that a large number of smaller institutions acting in a similar way can pose systemic risk. That is why we need a Financial Systems Stability Commission to assess the overall stability of the system and to direct corrective action.

Because regulation cannot be comprehensive, there needs to be a strong ring-fencing of the core financial institutions that are highly regulated. We have seen the danger of allowing them to trade with risky unregulated parties. But we have even forgotten basic principles: those who manage others' money inside commercial banks were supposed to do so with caution. Glass-Steagall was designed to separate more conservative commercial banking—concerned with managing the funds of ordinary Americans—from the more risky activities of investment banks, aimed at upper income Americans. The repeal of Glass-Steagall ushered in not only a new era of conflicts of interest (as we saw during the Enron/WorldCom scandals), but also a new culture of risk taking in what are supposed to be conservatively managed financial institutions.

There will be ancillary benefits in restricting banks' dealing with off-shore secretive banks, whose raison d'etre is, for the most part, regulatory and tax evasion, facilitating terrorism, drugs, and corruption.

Regulatory structures

Part of the problem has been our regulatory structures: if government appoints as regulators those who do not believe in regulation, one is not likely to get strong enforcement. We have to design robust regulatory systems, where gaps in enforcement are transparent. Relatively simple regulatory systems may be easier to implement, more robust, and more resistant to regulatory capture.

Anyone looking at our overall financial system should have recognized not only the problems posed by systemic leverage but also the problems posed by distorted incentives. But incentives also play a role in failed enforcement and help explain why self-regulation does not work. Those in financial markets had an incentive to believe in their models—they seemed to be doing very well. There was a party going on, and no one wanted to be a party pooper. That's why it's absolutely necessary that those who are likely to lose from failed regulation—retirees who lose their pensions, homeowners who lose their homes, ordinary investors who lose their life savings, workers who lose their jobs—have a far larger voice in regulation. Fortunately, there are very competent experts who are committed to representing those interests.

It is not surprising that the Fed failed in its job: the Fed is too closely connected with financial markets to be the sole regulator. This analysis should also have made it clear why self-regulation will not work, or at least will not suffice. (There are other reasons: each bank, in looking at its own risk, cannot ascertain systemic risks which may arise, say, when all use similar programs calling for sales of assets at the same time.)

Concluding comments on regulation

I noted that there has to be an alignment of private rewards and social returns. Those who impose costs on others (externalities) must be forced to pay those costs. This is not just a matter of equity; it is a matter of economic efficiency. More generally, costs of the regulating and bailing out of financial systems are part of the costs of financial intermediation. There is a presumption that efficiency requires that these costs be borne within the sector. In environmental economics, there is a basic principle, called the polluter pays principle. Wall Street has polluted our economy with toxic mortgages. It should now pay for the cleanup.

Moreover, financial behavior is affected by many other parts of our tax and legal structures. Financial market reform cannot be fully separated from reform in these other laws. While inadequacies in our financial system became so large that not even blind devotees could ignore them, there are serious failings in other aspects of our economy. There is, for instance, need for broader reform of corporate governance. Why is it that so many banks have employed incentive structures that have served stakeholders—other than the executives—so poorly?
Earlier, I talked about the need for stronger and more effectively enforced anti-trust laws. As part of the solution to our current problem, we are creating ever larger institutions—new problems for the future.

Our tax laws too have played a role in the current debacle. In spite of the new complexities resulting from so-called innovation, this financial crisis is similar to many in the past—there has been excessive leveraging. Tax laws, especially preferential treatment of capital gains, encouraged excessive leveraging. For this and other reasons we need to rethink this preferential treatment gains.

So too, new bankruptcy laws that made it more difficult for the poor to discharge their debts may have encouraged predatory lending practices. Reform in our bankruptcy law—including a new homeowners' Chapter 11—would help us in dealing with the rash of foreclosures and provide incentives against bad lending in the future.

Financial markets have become global. We exported our toxic mortgages abroad; had we not done so, the problems here at home would be even worse. But with open financial markets, there is a risk in the future that we might import toxic products produced abroad, unless other countries undertake serious regulatory reform as well. It is hard to see how our national financial market could work if we had to rely on 50 separate uncoordinated state regulators. Yet that is what we are, in effect, trying to do at the global level. There is a further danger: a race to the bottom, as each country believes that it can attract finance to its borders by deregulation. That view is wrong and dangerous. Investors want to put their money in financial markets that are well-regulated. They want to be sure that there is a level playing field and that they won't be cheated. In the past, one of the reasons that capital flowed to the U.S. was because investors believed our financial markets were well-regulated and worked well. Today, they have little confidence that this is the case.

It would be best if we could get an agreement on a global regulatory structure. At the very least, we should strive for a modicum of harmonization. We are at a "Bretton Woods moment," a moment where the international community may be able to come together, put aside parochial concerns and special interests, and design a new global institutional structure for the twenty first century. It would be a shame if we let this moment pass.

But we cannot let reform of our own regulatory structure wait on the outcome of international discussions. We can demonstrate leadership by showing what a good, comprehensive regulatory reform might look like. We can have good regulation in our country, even if others do not immediately follow. But that may well entail restricting dealings with those that have inadequate regulatory structures, as I have already suggested.

The agenda for regulatory reform is large. It will not be completed overnight. But we will not begin to restore confidence in our financial markets until and unless we begin serious reform.

FORECLOSURES

The start of our economic problem, in some sense, was in the mortgage market, but remarkably, too little has been done. Unless something is done to address the problems of foreclosures, banks will continue to face losses, and there is a risk of overshooting of real estate prices, as the effects of forced sales are felt. Given the externalities generated, government assistance to enable especially poor families to stay in their homes is imperative. There are large deadweight losses when houses are left vacant. The costs to society, to families and their communities, of the millions being uprooted, loosing with their homes their life savings and their dreams for a future are obvious.

The underlying problem is simple: banks made loans based on inflated housing prices; the mortgages were beyond many individuals' ability to pay. The following outlines a comprehensive approach to dealing with the problem of foreclosures. First, the voluntary restructuring programs have not worked sufficiently broadly and rapidly. It is time to back up these voluntary efforts with legal reform, a homeowners' Chapter 11. Secondly, in another version of trickle down economics, we have been throwing money at the big banks, in the hope that that will restart the economy. Matters have only grown worse, as we gradually discover the depth of their incompetencies in managing risk and allocating capital. It is time that we use some of the government's lower cost of capital to provide funds to homeowners. Taxpayers can even get a good return on these loans—far better than we are likely to get on the money provided to some of our financial institutions. Thirdly, we need to provide assistance to lower income homeowners; remarkably, today, we provide far greater assistance to upper income Americans through the tax system—paying approximately 50% of their housing costs—than we do to lower income Americans. Rectifying this is not just a matter of efficiency and equity; today, it is a critical step in addressing our economic crisis. Finally, as I noted earlier, our financial markets have been innovative—in getting around regulations and in creative accounting—but not in helping ordinary Americans manage the most important risks they face. There are alternative mortgage forms, such as Danish mortgage bonds, which have worked well; we need to begin exploring these alternatives.

1. Dealing with the current foreclosure problem: a homeowners' Chapter 11

There are a number of easy ways of dealing with the foreclosure problem—such as bailing out the lenders at the same time as writing down the loans—which, in the absence of budget constraints and worries about future moral hazard would make everyone (other than the ordinary taxpayer) happy. Individuals could stay in their homes, and lenders would avoid taking a hit to their balance sheets. Knowing that the government is taking this risk off of balance sheets would contribute to alleviating the credit crunch.

The challenge is how to save the homes of the hundreds of thousands of those who otherwise would lose their homes and *not* bail out the lenders, who should be made to bear the consequences of their failure to assess risk. (Clearly, borrowers also share in the blame, but for the most part, the lenders were, or should have been, far more financially sophisticated than the borrowers, especially most of those taking out sub-prime mortgages.)

One answer is a "homeowners' Chapter 11"—a speedy restructuring of liabilities of poorer homeowners, modeled on the kind of relief that we provide for corporations who cannot meet their debt obligations. Chapter 11 is premised on the idea that keeping a firm going is critical for the firms' workers and other stakeholders. The firm's management can propose a corporate reorganization which the Courts review. If found acceptable, there is a quick discharge of debt—the corporation is given a fresh start. The homeowners' Chapter 11 is premised on the idea that no one gains from forcing a homeowner out of his home. There are large transactions costs associated with foreclosure. And typically, following foreclosure, there is a deterioration in house maintenance, and adverse effects on the community.

Eligibility standards. This relief should be available for households with income below a critical threshold ($150,000) and with non-household, non-retirement wealth below some critical threshold (perhaps dependent on age). But an argument could also be made that it should be more generally available.

Procedures. The house would be appraised, and the individual's debt would be written down to, say, 85 to 90% of the level of that appraisal (reflecting the fact that were the lender to have to proceed with foreclosure, there would be substantial transaction costs).

An assessment of the individual's ability to make mortgage payments at the lowered value and current market interest rates would then be made (at a conservative standard—it again does no good to hope that the individual will be able to make payments that are beyond his ability).

If the borrower could still not make the now reduced payments, the borrower could then get a government loan as described in the next section, which takes advantage of the government's lower cost of funds. (To reduce the likelihood of foreclosure, this possibility could be extended more generally.)

Model bankruptcy restructurings for other cases (e.g. homeowners with an income beyond the $150,000 limit, or who can afford to pay the written down value of the mortgage) could easily be designed.

These restructurings, as desirable as they may be for the long run, are often criticized as being too slow to be of relevance in the current crisis. Regrettably, the crisis is likely to be long lasting. It is now clear that interventions which were supposed to have faster acting effects have not worked. Moreover, using model bankruptcy restructurings, it should be possible to have an expedited process.

2. Voluntary restructuring of existing loans

With the government assuming an increasing role in the financial sector (through ownership of Fannie Mae and Freddie Mac and equity injections), it can use its role to push mortgage restructurings (as it has already been doing in some cases).

The threat of a homeowners' Chapter 11 action would always promote voluntary restructuring.

In the next section, we discuss how government can use its lending programs to induce restructuring.

3. Expanded government mortgage lending

The usual argument *against* government lending is that the private sector does a better job of screening loan applicants and designing appropriate mortgages. The evidence against that view is now overwhelming. A simple rule-based government mortgage program could provide mortgages at better terms and with a lower risk of default than the private sector. There are a number of variants of this proposal (some already in place at a limited scale). By passing on the government's lower cost of capital, and using the enforcement capacities of the IRS, loans could be provided at lower interest rates, without adversely affecting the government's budgetary situation, and these lower mortgage rates would then lower default rates.[1]

Note that the government (sometimes through the Federal Reserve) is providing financing at lower-than-market price to large corporations and banks. A compelling case, both on grounds of equity and efficiency, can be made that it should also do so for ordinary Americans.

Refinancing existing mortgages. With long term interest rates at record low levels, it may be possible to refinance large numbers of mortgages in ways which will make them affordable—and still leave the government earning a return. The threat of the government doing so may itself provide an incentive to encourage banks to restructure their loans. If the government refinances, say, a 6% mortgage, the bank receiving the money may have few good investment opportunities.

The government could, for instance, offer to refinance all mortgages that have not been restructured according to government specifications. The low interest rates have, in effect, given owners of long term mortgages paying higher interest rates a windfall gain, though the mortgage may still have a low value because of the risk of default.

In some cases, there is a pre-payment penalty. The savings from the lower interest rate would, presumably, in most cases more than offset the pre-payment penalty, and the government could provide finance for the pre-payment penalty as part of the refinanced mortgage. The government could use the homeowners' Chapter 11 to override the pre-payment penalty, or alternatively offer to pay the penalty, on behalf of the homeowner. The costs of such payments are likely to be low, especially in relationship to the costs of the current disruptions in financial markets. Alternatively, the government could combine an override under a version of a homeowners' Chapter 11 with a partial payment of the penalty in those instances where the lender could establish that he: (i) had fully disclosed and explained all the terms of the mortgage to the borrower, including the pre-payment penalty; (ii) had not made any representations about the likelihood of price increases; (iii) had not engaged in other abusive lending practices; and (iv) but for the government intervention, would have had a likelihood of having the loan fully repaid.

Government Subsidies. Some have proposed using TARP to provide subsidies to homebuyers, though not to help subsidize refinancing. The argument is that such subsidies (proposals being currently discussed amount to a 10% reduction in price) would encourage more demand for housing and thus boost house prices. We face a quandary: we want house prices to adjust to the "equilibrium level," which may entail a further reduction from the current level. Resisting that will simply extend the duration of adjustment. (One can debate whether a longer and possibly shallower downturn is preferable to a shorter and deeper downturn. But at the very least, one should be aware

[1] We can think of this as a form of benchmark competition. If the private sector can provide loans at a lower interest rate, so much the better.

of the downside risk associated with interfering with the adjustment process.) On the other hand, we do not want to "overshoot." We are not yet at the point where we are likely to have overshot. But we may be at that point within a year or so. [2]

Note that there is something peculiar about not subsidizing individuals to stay in their existing homes, but subsidizing the purchase of homes, particularly if the interventions are not fully effective in stopping the slide in house prices. It would mean we would look the other way as foreclosures occur—with all the economic and social costs. This can be looked at as another example of trickle down economics. We hope that those suffering the most are helped by helping others. It probably makes more sense to help those who are likely to face foreclosure directly.

Recourse loans. In addressing the mortgage foreclosure problem, there is one modification that should be considered. If the mortgages provided by the government were full recourse mortgages, default rates would be greatly reduced, because individuals would know that they could no longer simply walk away from their debts. This would enhance a "credit culture," which would improve the functioning of credit markets.

A recourse mortgage should, obviously, be less attractive to borrowers. Most borrowers do not plan to default, and therefore they would probably be willing to take up such a mortgage at an interest rate little different from that on a non-recourse mortgage.

But this restructuring of debt provides a major gift to lenders: the reduced likelihood of default increases the value of that part of the mortgage which they retain. They should not be given this "gift" freely. There are social gains from the reduced likelihood of default; these need to be equitably distributed.

Here is one way that that could be done: in the case of banks willing to go beyond the framework of the "homeowners' Chapter 11" outlined above, and say write down the mortgage to 75% or 80% of current market value, the government would provide a *recourse* mortgage, charging the homeowner a slightly lower interest rate (say 25 basis points lower). Everyone wins from this proposal.

Separating speculators from true homeowners

One of the objections to these restructuring proposals is that speculators as well as true homeowners may reap the benefits. It is the latter, of course, whose welfare is of particular concern.

One way of addressing the problem is to restrict eligibility to those who are and have been living in their home. Only primary residences would be eligible.

[2] The benefits may be limited by the fact that, if the interest rate is too much below rates at which current homeowners have financed their homes, some individuals may be induced to sell their homes, to get the low interest mortgage. Thus, the program may have supply side effects partially offsetting demand side effects.

But there is a second approach, based on what economists call the general theory of self selection. After the write down, the lender would retain a share (perhaps all) of the capital gain, to be paid when the property is sold. Speculators would have little (or no) interest in participating, since the debt restructuring would take away all of his speculative gains.

There are some technical difficulties. One would have to take some account of investments in the house made subsequent to the restructuring. The effectively high tax on capital gains could lead to a locked-in effect. It would make it costly for individuals to move, since they would then have to pay a potentially large sum to the lender.[3]

Note that with such conversion of the former creditors into equity owners, the analogy with Chapter 11 is complete. In Chapter 11, the equity owners are wiped out (here the equity owner is the homeowner, and, if he retains none of the capital gain, his equity claim is fully eliminated), and the former bondholders become the new equity owners.

One could design variants around this theme. One could, for instance, give homeowners a schedule, with large write downs of the mortgage granting larger fractions of the capital gains to the lender.

4. New Mortgage Forms

Ironically, the financial sector, for all of its claims at innovation, has not innovated in ways which are directed at shifting risk from poor Americans to those who are more able to bear the risk. Indeed, variable rate mortgages shifted risk of interest rate variations to homeowners. Other products with balloon payments were even worse.

There are a number of products which have been developed in other countries which could be introduced into the United States. For instance, the Danish mortgage bond is an alternative structure which has proved successful for more than two centuries.

The government has repeatedly had to take the initiative in innovating financial products (like making mortgages widely available) that meet the needs of ordinary citizens. When they are proven, the private sector often steps in. This may be another instance where government will have to take the initiative in designing new forms of mortgages and in ensuring an adequate supply of mortgages because of the failure of the private sector to do what it should.

[3] There might also be problems of circumvention: two homeowners in a similar position could exchange their homes after the restructuring, wiping out the future capital gain claim, though it should be easy to restrict or discourage such attempts at circumvention.

5. Expanded homeownership initiative

Advocates of the reckless subprime mortgages argued that these financial innovations would enable large numbers to become homeowners for the first time. They did become homeowners—but for a very short time, and at a very high cost. The fraction of Americans that will be homeowners at the end of this episode is likely to be lower than at the beginning. The objective of expanding homeownership is, I believe, a worthy one, but clearly the market route has not worked well—except for the mortgage brokers and investment banks who profited from them. They encouraged individuals to buy housing beyond their ability to afford and to repeatedly refinance, generating large transactions costs for themselves. This was never the intent of those advocating expanding home ownership. The irony is that the policies of "reckless lending" contributed to the housing price bubble, so in the end, the homes that poor Americans wound up purchasing were no larger than they would have been, without the bubble and without the reckless lending. Now, the problem is that these people are not only losing their homes; as they lose their homes, they are also losing their life savings. Mortgage brokers and lenders should have encouraged homeowners to purchase houses that were appropriate to their income.

The underlying problem is simple to state: median household income has been falling and house prices rising. This means that housing is becoming less and less affordable to more and more Americans. There are no easy fixes to the declining incomes (other than shifting the burden of taxation away from these individuals and towards those who have been doing well. Nor is there any way (short of public housing programs) that we can quickly reduce housing prices. (The market correction currently going on is likely to make housing more affordable.)

In general, most economists worry about the distortions from our tax system in encouraging excessive consumption of housing. But given the magnitude of the current economic crisis, further assistance may be warranted.

A particularly strong case can be made for helping low income individuals with their housing costs. Note that we do this with upper income individuals—tax deductibility of mortgages and property taxes means that the government pays a large fraction of the carrying costs. But ironically, we do not do that with those who need the help the most.

A simple remedy is converting the current mortgage and property tax deduction into a *flat rate cashable tax credit at say 25%*; the reduction in the subsidy to upper income Americans could help pay for the subsidy for poorer Americans. (Even better would be a progressive subsidy, with a higher rate for the poor than the rich.) A 25% tax credit would increase the affordability of housing for many Americans.

6. Regulations

Many countries restrict predatory lending practices and even loans which impose excessive risk burdens on low income individuals (and which, as we have seen, not only risk the well being of those individuals, but also impose systemic risk on the economy).

We should do the same. We should not allow mortgages that present a risk that payments might exceed a particular fraction of household income, and mortgage programs that, as a matter of routine (e.g. as a result of patterns of refinancing), generate transactions costs that are in excess of a certain fraction of the value of the mortgage.

The proposed Financial Products Safety Commission, discussed briefly earlier in this testimony, might be an appropriate institution for reviewing what are "safe" mortgages and for setting out guidelines on the appropriateness of particular mortgage structures for individuals in different circumstances.

EVALUATING TARP: SOME PRELIMINARY THOUGHTS

We have now spent close to $350 billion, and the President has requested the second tranche. The results of the spending of the first amount have been, to say the least, disappointing. The money has not been spent in the way it was originally going to be spent. Small and medium sized businesses claim that credit is more difficult to get, and large businesses are obtaining much of their credit through the Fed, which has moved from becoming a lender of last resort to a lender of first and only resort. There is broad consensus that American taxpayers have gotten a very bad deal, at least in comparison to terms obtained by Warren Buffet and by other governments. Changes in stock and bond prices seem to confirm that we have given bondholders and shareholders a very good deal indeed.

In my analysis below, I explain some of the reasons for the failure of TARP and some of the reforms. Let me say, up front, that I feel very strongly that no more money should be provided without greater assurances that it will be well spent. It seems we have provided ample evident to the old adage of penny-wise and pound-foolish. While we quibble whether America can afford a few billion dollars to provide health care for poor American children, in a few short weeks, we have managed to squander hundreds of billions of dollars on the very parties who brought this country to economic ruin. We need to be as careful in spending TARP money as in shaping the stimulus—focusing on bang for the buck and consistency with our long-run vision. Our focus should be on maintaining the strength of the overall economy, not on preventing losses of shareholders and bondholders. We should rely less on trickle down economics, focusing more of our attention on helping those directly in need.

An analysis of objectives

To evaluate TARP, we have to be clearer about the nature of the problem and the objectives. Ostensibly, it was supposed to maintain the flow of credit. The failure of the flow of credit to be maintained is seen as a symptom of its failure. But even the flow of credit is an intermediate objective: the ultimate objective is maintaining a strong economy.

I believe TARP has failed and needs to be restructured. There have to be changes in both how new funds are provided and in the terms under which funds were previously provided. Banks that do not cooperate in changing their behavior should be dealt with forcefully.

The direct intent of the bail-out was clearly to maintain the flow of credit, to ensure that those who wanted to buy homes appropriate to their economic situation could do so, that healthy firms could still obtain working capital and funds for new investments, and that retailers and wholesalers could obtain the necessary trade credit. To do so, we have to maintain the integrity of the payment system. Without an adequate supply of finance, there would be a reduction in both aggregate demand and aggregate supply and an increase in unemployment, with both contributing to a downward vicious circle.

Maximizing bang for the buck. Especially given the size of the fiscal deficit and debt, it is important that the spending be well-targeted. In the design of a stimulus, we argue for maximizing bang-for-the buck and the timeliness of the effects. So, too, in the design of bail-outs.[4] We are, of course, concerned about the impact on the national debt in the long run; that is why the terms of the bail-outs are so important. Adverse terms increase the likelihood of losses. But given the huge risks (which the private sector finds impossible to evaluate) making judgments about long term losses is not easy. The bail-outs may, in addition, be plagued by problems of information asymmetries: without adequate procedures, tax payers may wind up with the worst assets.[5]

Lending in some sectors may have bigger bang for the buck than others. For instance, lending to consumers may help retailers and may lead to more sales of imported TV's and other durables, but the impact on employment may be limited. Non-discrimination provisions make it difficult to target consumer lending on goods which will have an employment multiplier.

Central to the analysis of maximizing the immediate bang-for-the buck is ascertaining whether the bail-outs will lead quickly to more lending. Enhancing bank balance sheets might make them willing to lend more *once the economy recovers* but might not lead to more lending now, given the inherent uncertainties. That in fact seems to be the case.[6]

---

[4] As always, we need to distinguish short run and long run budgetary impacts. Some defend the bail-outs, arguing that we will get our money back. The same is true of many other public investments in infrastructure and technology. Indeed, a CEA study suggested very high returns to government expenditures on research. There is still an opportunity cost. In the case of the bail-outs, there is considerable risk that the public will not fully recover the funds (especially taking into account these opportunity costs and appropriate compensation for risk).

[5] This was a particular concern in the original conception of TARP, in which the government would acquire particular troubled assets.

[6] There is another aspect of the bail-outs—they may diminish the speed of deleveraging. A firm can sell assets to raise capital, but as each firm tries to sell its assets (to others who are trying to do so simultaneously), the value of assets declines. The system-wide sale of assets to raise capital turns out to destroy capital. The bail-out across the system lowers the urgency of the need to sell assets and therefore may diminish the pace of deleveraging. But if (as most economists believe to be the case), there must eventually be a dramatic deleveraging, prices will eventually have to adjust. Thus, the bail-outs may prolong the adjustment period.

Another aspect of maximizing the bang for the buck is that it may be better to target the ultimate source of concern. If we are worried about how the failure of firm A might affect pension fund B or money market fund C, it may be better to provide some assistance to the pension fund or money market fund (e.g. the latter through a partial guarantee), than to rely on trickle down economics. Otherwise much of the money will trickle away.

The failure of AIG may have led to the failure of other firms, as we noted earlier. It will certainly lead to losses of other firms. But we need to know, how extensive would these failures be? If we need to prevent these second round effects, it might have been more effective to target assistance on these firms. [7]

It was *not* intended to bail-out investors (in either debt or equity instruments) who had made bad investment decisions. To be sure, such losses will have ripple effects. Some pension funds may have to be made whole. But to throw billions and billions at the banks is an inefficient way of protecting these pension funds.

Sustainability. A further concern is *sustainability.* No one wants a bail-out today to be followed by a further bail-out tomorrow. There is a worry that we will continue to throw good money after bad. The way the bail-outs have been conducted provides grounds for concern. We were first told that AIG had a short fall of $20 billion. We have now put in $150 billion. But the money going to AIG has not stayed there. It has gone elsewhere.

Long term vision and environmental concerns. Just as stimulus spending should, to the extent possible, be consonant with our long term vision—no one defends simply digging holes and refilling them as a way of generating employment—so too for lending.

The financial sector has engaged in a number of bad practices and has played an important role in perpetuating certain economic distortions.[8] As we address our short-run problems, we do not want to exacerbate our long-run difficulties. Government interventions should be aimed at preventing new short-run distortions which might arise from mismanagement of the crisis (e.g. an *overshooting* of prices); but it should not just postpone needed adjustments of the economy into the future.

America's problem, for instance, is not too little consumption but rather too much. Encouraging consumption today just postpones the eventual day of reckoning. It may still be justified, as part of short term adjustment measures, but we should be wary.

---

[7] Though there has not been transparency about where the $150 billion provided has gone, it is certainly likely that some of it went to parties that were not of systemic consequence—and some may have even gone abroad. Arguably, it would have been better to ring-fence the "real" insurance part of AIG, and, should any firm of systemic consequence face the problem of bankruptcy because of the failure of AIG as a counterparty, provide limited assistance directly to that firm.

[8] These distortions have extended beyond the financial sector. It encouraged a short term focus that has, for instance, contributed to the problems in the automobile industry.

Housing presents a particular problem. America's decisions concerning the quantity of housing have been distorted by tax preferences and distortions in our transportation system. In the long run, we need to adjust the quantity and pattern of housing. Broad programs to subsidize housing to support price levels may again be justified as part of a short term adjustment measure, but again we should be wary. It would be better to try to target housing assistance, both to those who are most in need and to the construction of environmentally sound housing consonant with better models of land usage.

Equity, moral hazard, market distortions, and other concerns. The government should not be in the business of making firms whole that fail in their risk-analyses. It is unfair to those that did a good job of risk analysis, and it undermines incentives—the classic moral hazard problem. There is concern that government funds may have gone to those who purchased credit default swaps without doing due diligence on counterparty risk. If this were the first time that America's banks had had to be bailed out, that would be one thing; but America's financial institutions have had to be bailed out repeatedly.[9] It is critical to understand that one can maintain financial institutions (or other institutions) and, at the same time, impose severe penalties on those who have not performed their responsibilities, i.e. by firing managers, and making shareholders and bondholders pay a heavy penalty. Indeed, this is what Chapter 11 of the bankruptcy code is supposed to do.

Bankruptcy. It is important to recognize that bankruptcy does not necessarily entail the cessation of activity of the affected enterprise. Chapter 11 is designed to allow firms to continue to operate. What it entails is that shareholders get wiped out, and bondholders may lose a substantial fraction of their net worth. Most of the bail-outs are really bail-outs not of the enterprises but of shareholders and especially bondholders. There is no reason that American taxpayers should be doing this.

One might argue that even Chapter 11 bankruptcy is particularly dangerous for financial firms because it will result in a lack of confidence. In the current context, such arguments are unpersuasive. There is no confidence in these institutions. Indeed, this is why the interbank market is frozen. Eliminating fixed claims and converting them to equity claims will in fact increase confidence that these institutions can meet other obligations. If more is needed, the government can provide this through guarantees, which it is doing in any case. From this perspective, bondholders may be the really big beneficiaries of TARP.[10] And spending money to bail out bondholders may be a particularly poor use of government money.

Market distortions. Still a further concern is to avoid market distortions. TARP and other bail-outs have involved picking winners and losers, bureaucratic interference in

---

[9] Many of the bail-outs, like the Mexican bail-out, bear the label of the country that was doing the borrowing. But every loan has a borrower and a lender; America's financial institutions provided funds beyond these countries' ability to pay. They failed to perform the central role of ascertaining credit worthiness. (Indeed, I have argued that they were really not bail-outs of the countries, who had to repay the loans, but were really bail-outs of the Western financial institutions. This issue of who is the real beneficiary of the bail-outs is relevant in the context of ongoing discussions of the automobile industry bail-out.)

[10] There are some calculations which suggest that that was the case for the original equity injections.

market processes. We have given big advantages to some firms over others; we have been rewarding failure rather than success. And we have provided high returns to rent seeking behavior through the political process.

Inevitably, such interventions have hard to predict and hard to control ripple effects. Providing unlimited guarantees to money market funds puts them at an advantage over banks, forcing an increase in deposit insurance for banks. That may have been the right policy, but it illustrates systemic sensitivity.

With the Fed buying commercial paper from large enterprises, it provides an unwarranted advantage of large firms over small firms—a subsidy which should be of particular concern given the role that small firms play in job creation.

Furthermore, it puts the Fed in a difficult position of judging risk—one for which it is ill-equipped. How do we know that the interest rates being charged correctly reflect the risk of default? Again, we either make no distinctions, or we are forced to substitute bureaucratic judgment for the marketplace—with taxpayers left to bear the consequences of flawed judgments. This will be increasingly important over time, as the economic circumstances of firms change dramatically as the economy goes into recession.

Charging interest rates below the level which they would be is a hidden subsidy, gives rise to a market distortion, and can be viewed as an unfair trade practice, actionable under WTO countervailing duties provisions.

The lower funding costs that come from making whole all of the bondholders is, in effect, a subsidy to leveraging—it exacerbates the moral hazard of excessive leveraging, which has contributed so much to the current crisis.

The Fed may need to be more sensitive to the indirect and possibly unintended effects of some of its policies, particularly as they interact with TARP. For instance, with the Fed now paying interest on deposits at the Fed, it reduces the incentive for banks to make loans. Income effects (the improvement of bank balance sheets) and substitution effects work in opposite directions, with uncertain net effects.

The manner in which the bail-outs have been conducted creates two further long-run problems. By enhancing consolidation, they increase market power. The problem of too-big-to-fail has become even bigger. It provides incentives for still further consolidation. And as banks become too big to fail, incentives for excessive risk taking are increased.

Systemic importance. There is further distortion in the approach that says we will bail out systemically important institutions and not others. It increases the cost of the capital of the latter relative to the former.

Moreover, while each of the smaller institutions does not have systemic effects, the set of smaller institutions together does have systemic effects. When the problems they face are a result of common shocks (a common macro-economic shock, or a common flawed practice), something has to be done to protect these institutions. This is especially the case because many of these institutions may be more related to lending directly than the larger institutions, which are more engaged in the "moving business."[11]

Moral hazard. While bail-outs always pose the risk of moral hazard, the manner in which the bail-outs have been conducted has, at times, increased the problems of moral hazard. Had we, for instance, forced the executives, shareholders, and bondholders to pay a bigger price, the moral hazard problem would have been mitigated.

Note that some argued against helping homeowners facing foreclosure on the grounds of moral hazard—at the same time defending the bail-outs of the major banks. There is, in fact, no real moral hazard problem for those facing foreclosure on the house they owned and into which they put their life savings: these individuals were typically misled by mortgage brokers, who were supposedly more financially sophisticated, into buying homes beyond their ability to afford and with mortgages which imposed undue risk. There may be a separate problem for those who bought several homes for purposes of speculating, and the approach to foreclosure described below seeks to separate out these two cases.

We need to recognize that any bail-out program will generate some inequities—banks that managed their risk well are not receiving government help, while those that did not will be; homeowners that bought homes beyond their ability to pay may receive help while those who have been more prudent will not. We should not ignore these concerns of equity; they should inform carefully the design of bail-outs. We should make sure that the financial sector pays for its own bail-out and that the burden is paid especially by those parts of the industry that have received the bail-out and not shifted to other parts of the industry, to new entrants, or other sectors of the economy.

Transparency and democratic accountability. Finally, it should have been an objective of the design of the TARP program that the bail-outs be conducted in a manner consistent with democratic principles of transparency and accountability. In many cases, they could not have been more opaque. We still do not know how, and at what date, the market valuations of the assets acquired were determined. We do not, accordingly, know the risks which we as taxpayers face.[12]

There may be a trade-off between maximizing the bang for the buck and transparency. Government guarantees of private sector loans impose little cost today. But they are not costless. In principle, the private sector should be charged a premium commensurate with the risk. But the private sector assessment of risk is currently so high that charging such a premium might impede the credit flow. Charging less than that amount is an

[11] See the discussion below relating to changes in the underlying economic model.
[12] The Citibank bail-out (which, reportedly, Citibank officials were congratulating themselves on how good a deal they got) is an example of a non-transparent bail-out. There is a loss sharing agreement between the government and Citibank, but no one knows where the "starting gate" is. At what price are those assets when they enter the agreement? Par? Last mark?

implicit subsidy. Scoring of the subsidy is likely to be difficult. Efforts should be made to ensure that the assumptions underlying the scoring are transparent.

An analysis of the Economic Problem

TARP was originally directed at helping revive the financial sector. It was based on two flawed assumptions. The first was that the main problem was a lack of confidence. If the government showed that it was willing to support the industry, confidence would be restored, and in fact the money would not need to be spent. There were multiple equilibria to the economy, a low level equilibrium with low confidence, low growth, etc, and a high level equilibrium. The announcement of the program would shift the economy from the low level equilibrium to the high level equilibrium.

The second, related assumption was that the banks faced a liquidity problem, not a solvency problem. Providing short term financing would provide the necessary liquidity, restart the economic engine, and all would be well.

The problem, however, was that many banks had made many bad loans and engaged in many risky bets. They had lent on the basis of over inflated housing prices. 25% of mortgages are underwater. Many of these have defaulted; many more are likely to default. Prices are likely to decline further before they reach their equilibrium values. The banks will experience real losses on these defaults. Investors know this. These are the harsh realities which the original design of TARP did not want to face up to.

The reason that firms typically face liquidity problems is that market participants are not confident that firms can repay money lent. Hence, typically, liquidity problems reflect a judgment by market participants that the firm in question faces an insolvency problem. Of course, the management of the firm will typically say, no, the market is underestimating our true worth. The Secretary of Treasury (normally committed to market processes) substitutes his judgment for that of the market. We should be skeptical.

The problem is not just one of transparency, but also of complexity. Given the complex gambles that the banks had undertaken, their failure to adequately appraise risks (including counterparty risk), they knew that they didn't know accurately their own balance sheet; they were exposed to enormous uncertainties. So they knew that they couldn't know that of other banks to whom they might lend. Complexity of assets and derivatives made it nearly impossible to measure and credibly convey solvency to counterparties. No one can prove they are solvent. This has provided a field day for short sellers.

The consequent seizing up of the interbank lending market was of direct concern; but it should have been of more concern as symbolic of the deeper problems in the financial system.

The overall problems facing the financial sector included: (a) there was excessive leverage; (b) which fed a housing bubble and other inflated asset prices; (c) which in turn fed excessive consumption; (d) bad lending; (e) bad risk management—banks engaged in gambling; instruments that should have been used to mitigate risk were abused in ways that enhanced risk; and (f) bad accounting, including off-balance sheet activities, intended to deceive investors and regulators.

The economy is going through a process of deleveraging. At the end, there will be lower asset prices. Financing these assets will require less credit. There will also be more prudent lending. We will go, for instance, from providing 95% of the value of an over inflated house to 80% of a more reasonably valued house. The net effect is that there will be less housing credit outstanding. The process of adjustment necessarily will involve credit contraction. It will also involve an increase in the savings rate—which will be good for the economy in the long run, but painful in the short run.

What we want to avoid, however, is a more than proportionate reduction in the availability of credit for the purchase of new homes, and even more importantly, a reduction in trade credit and working capital. The problem is that we have been approaching the problem with blunt instruments, not clearly distinguishing the various forms of credit, not focusing on the extent to which a particular bail-out will really address the credit problems on which we should be focusing.[13]

There is a second important problem in assessing what should be done: the banking model has changed; as the investment banks commonly put it, they have changed from the storage business into the moving business. To a large extent, they neither originate loans, nor hold them. Critics might also say they have also moved into the insurance (or gambling) business.

Looking at the financial system overall, it is clear that the decrease in its net worth, combined with deleveraging, falling housing prices, recession, and increased risk will affect adversely both the ability and willingness of financial institutions to provide funds. With limited amounts of funds and a looming national debt, we have to provide funds carefully. We need to think about what we can do to affect the ability and willingness of financial institutions to bear risk, and the nature of the risks which they face. (The overall framework for thinking about bank lending, under the old regime where banks actually lent, is provided by Greenwald and Stiglitz, *Towards a New Paradigm of Monetary Economics,* Cambridge University, 2003.)

We need to target help to those institutions that are most likely to affect, for instance, the supply of *new* housing credits, credits for new investment, and trade credit and working capital. Under the old bank model (and there are still many local and regional banks that adhere to that model) banks originated and held loans. Their willingness and ability to

[13] Part of the reason for this is the belief that the large firms are so intertwined that failure of any one could bring down all of them. It may be possible, however, to split these large organizations into parts, allowing some of the parts to fail, while preserving those parts which perform essential functions. Currently, there is so little transparency that it is hard to ascertain whether this is the case.

originate loans was affected by their net worth—decreased by the losses on existing mortgages. Recapitalization through equity injection was designed to help these banks be able and willing to bear more risk. But allowing banks to decapitalize, paying out money in bonuses, dividends, or through the cash acquisition of healthy banks subverts the intent of recapitalization.[14]

Many of these banks also had very risky assets in their portfolio. Having the government exchange these assets for their fair market value would presumably have reduced the riskiness of bank portfolios, and again allowed them to lend more. The problem with this approach was the difficulty of valuing the risky assets. And proposals to force the bank to bear part of the downside risk obviously undermined the intent of reducing the uncertainty of banks' portfolios.

That is why an alternative approach may have been far better: spending at least part of the money to create new lending institutions without the historical legacy of debt. This is particularly relevant since so much lending activity has moved outside of classical banking. (The information acquisition and processing has been outsourced, and therefore could presumably be acquired relatively easily by newly established institutions.)

This is particularly the case for mortgages. It would have been far better to create new institutional arrangements (along the lines of the Danish mortgage bonds) than to waste money on resuscitating failed institutions. (The similarity between the problems faced by the former Communist countries is instructive. China took the approach of creating new institutions; Russia attempted to revive old institutions. We know which country won that contest.)

The contrast between what might have been achieved had we used the money for new institutions as opposed to picking up losses in the old is illustrated by the following thought experiment. Assume $500 billion was used to finance a new set of banks, and those banks had a 12 to 1 leverage ratio. $6 trillion in new loans could have been financed—more than enough to sustain the core credit flow for working capital and trade credit, even if many institutions had gone under.

The moving business is a business that is far less important to preserve than traditional banks. Entry is relatively easy. Indeed, the barrier to entry in the past has been reputation, but most of the existing firms have had their reputations shattered, perhaps beyond repair. De novo firms might be better than existing firms in this context.

Here, our concern is the interlinking of debt—the worry that the failure of one institution will lead to the failure of others, a cascade with systemic consequences; and especially of their limited, but still important, role in the payments system, evidenced by the problems arising out of Lehman. It is clear that that is where we should have focused our attention (and after the fact, we did that). We should not, however, be so concerned with losses of shareholders and bondholders.

[14] As noted earlier, equity injections may also slow the pace of deleveraging; but this benefit, too, will be attenuated if banks are allowed to pay out dividends, bonuses, etc.

There are two further reforms, one focusing on the supply side, the other affecting both the demand and supply side. One of the impediments to bank lending is uncertainty about their balance sheets, caused by the massive derivative/swaps gambles on their balance sheets. Hence, what should have been done is a comprehensive netting of swaps, which would have reduced the scale of uncertainty. Some of this is already going on.

Reforming TARP

There are a large number of small and large reforms to TARP that would make it more effective.

1. No dividends, strict limitations on bonuses, and no acquisition of healthy banks for cash with the cash injected into the banks. It makes no sense for US taxpayers to be pouring money into the banks as they pour money out. Moreover, the main beneficiaries of allowing money to pour out are shareholders vis-à-vis bondholders. (Sometimes, it is argued that restricting dividends will send a negative signal to the market, harming shareholders. This argument is unconvincing: the market knows the magnitude of the bank losses. Indeed, the restriction on paying dividends attenuates any information signal.)

2. Better targeting and terms that ensure the government gets an appropriate return, with downside protection and upside potential (reflecting the risk the government bears). The criterion should not be simply that the government recovers the money it has lent. There is a high opportunity cost of funds and a high level of risk bearing. There are other potential claimants on access to U.S. government funds. Firms have been lining up to get TARP money. Some, like AmEx, seem to believe that once they are a bank holding company, they can tap into the money, even if there is little relationship between their activities and the original intent of TARP. Once one says that any firm that is engaged in some lending activity might be eligible for a bail-out, what are the limits? The fact that so many find the terms attractive suggests that the government is not driving as hard a bargain as it could or should. *We should be working to target the money more directly to the areas where it should be going.* Hence, we should require financial institutions that seek assistance to "carve out" a separately capitalized narrow bank subsidiary, to provide working capital, trade credit, capital loans, small business loans, etc. The government could help capitalize this narrow bank, taking appropriate ownership share in proportion to the capital it provides.

   When the terms provided by Paulson are compared to the terms on which Buffett provided money to Goldman Sachs, the best capitalized of the investment banks, or to the terms at which the UK provided money, it is clear that the US taxpayer did not get a good deal. Further evidence is provided by changes in share and bond prices on the announcement of the terms of the deal. The terms need to be renegotiated, especially for any financial institution seeking further government assistance (explicit, or implicit, through Fed acceptance of anything other than T-bills as collateral).

What should the terms of an equity injection look like? There are several terms of the bail-out that are crucial. It seems to me that the bail-outs should have been structured to prevent (or at least mitigate) unintended bondholder gains, to provide downside protection to the government, and full risk-adjusted compensation to taxpayers for the provision of capital. Meanwhile, while the crisis continues, one doesn't want to draw down the banks' capital by interest/dividend payments. Here is how it could have been done:

a) Cumulative preferred shares, convertible to senior debt instruments in the event of bankruptcy (or at the option of the government), and convertible to shares (with a particular conversion ratio chosen to ensure adequate risk compensation for the government). No dividends to be paid out until (i) profits are restored and (ii) lending is restored to certain critical levels. This provides incentives to restart lending.
b) This basic structure could be accompanied by further downside protection, by the issuance of senior debt as part of the package, with no interest due for x years.
c) It could also be accompanied by further upside sharing of gains, by the issuance of warrants. The key provision is pricing (how much below current prices) and timing of exercise. There is a compelling argument that it makes little sense for government to be adding capital once the market is recovered—hence upping the ratio at which preferred shares can be converted into common shares seems more reasonable.
d) Protection of existing shareholder against dilution. Allowing existing shareholders to participate in the issue through a right issue (and diminishing the government capital injection a corresponding amount) would mean that no shareholder could complain about dilution. He had the option to participate on the same terms that the government did, but chose not to.
e) Buying out the government. The firm could replace government equity with private equity at any time of its choosing. A critical feature should be the rate at which the government can be bought out: it should reflect the risk that the government has borne, e.g. a cumulative rate of real return (adjusted for inflation) between the date of capital injection and the date of buy-out of, say, 7%. This would provide a strong incentive for the firm to replace government capital with private capital, once it has been restored to health.

Even with these terms, there is a risk of underpricing, so that taxpayers will confront losses. There is uncertainty about the appropriate terms, and there may be an incentive to give the banks excessively favorable terms, reflected in an increase in share value. This certainly has been the case in the deals so far. There seems no way of fully protecting against this risk, though a commitment that the sector repay fully all funds advanced (with risk-adjusted interest), through an industry tax on the firms who have been bailed-out once recovery returns would provide some protection.

3. A quid pro quo for receiving money would be the adoption of best lending, corporate governance, risk taking, and incentive practices. This would entail, among others: (a) no predatory lending, including the reforms on credit card practices in the bills before Congress; (b) no exposure to derivatives or swaps unless explicitly linked to the mitigation of some risk exposure; (c) reforms in corporate governance, including full expensing of stock options; (d) reforms in incentive systems, including those which lead to excessive risk taking and excessively myopic behavior; and (e) reforming mortgages (separate topic).

There are two arguments against these and other reforms discussed below which impose constraints on banks. The first is that they will make it less attractive for the private sector banks to recruit more private sector capital. Obviously, if the government gives away money, it is easier to recruit others to help share in the largesse. But a convincing case has to be made that this is the best way of using limited government funds. Why, for instance, is it better to recapitalize an American bank using money from the Kuwait government than from the American government? Will it result in a greater flow of credit? Better lending practices? Less risk to the American government? So far, I have not heard a convincing case.

The second is that it is wrong to change the terms of a contract (reforms that might affect the old bail-outs) or it is unfair to provide terms to the new bail outs that are different from the old bail-outs. It would put these firms at a competitive disadvantage. We are dealing here in a world of second best, including imperfect equities. American taxpayers view it as unfair that the bankers who did so well in the run-up to the crisis should now be bailed out. Those banks who managed their business well view it as unfair that those who did not should now be the beneficiaries of government largesse. To me, the most important economic (and political) issue is to ensure that the macro-economic benefits derived from the bail-outs are maximized. The existence of these macro-economic benefits is the only justification for the government largesse. The banks knew that there was a quid pro quo, that the government was providing them with this money because of the overriding importance of macro-stability. And we do not want to reward hostage taking. Besides, the government is always changing the terms of an implicit and incomplete contract. Taxes are increased or decreased. The Fed is now accepting a variety of assets as collateral, a change in policy which increases the franchise value of a bank. (Sometimes, the two arguments are linked: a change in the terms of the deal will make it more difficult to attract capital. In fact, it will be difficult for most banks to attract capital, until the economy begins to recover, heightening the importance of the macro-economic focus.)

4. Actions have to be taken to increase lending. This is difficult, given the claim that banks may make that there are no good lending opportunities. One approach (used by the British government) is to require banks to set aside certain sums for particular categories of lending, creating organizational incentives for finding lending opportunities within those categories. Another approach is to restrict the payment of dividends until after lending is sufficiently increased.

5. There should also be more careful consideration of the purpose for which we want credit. Facilitating refinancing of existing mortgages will be of benefit to the homeowners, but should probably have lower priority (except when the lower payments forestalls a foreclosure) than say lending for working capital or trade credit. America's problem is that we have been consuming too much; supporting credit card lending again should probably have lower priority than lending for working capital. The question is, how best to direct credit to these essential areas?

6. There should also be more careful targeting to institutions whose responses are more likely to have significant macro-economic consequences (per dollar lent), and that may entail a disproportionate amount of money going to smaller institutions, and even some going to expand healthy institutions, including community banks. Such institutions, unburdened by flawed lending and risk management practices, and with more local information, may use the additional money to increase lending.

7. The government should require all banks to recapitalize up to, say, 10% or 12%. TARP money would be used to recapitalize the (narrow) banks that cannot find private capital. After recapitalization, the capital requirements would be lowered, say to 8%. This would provide banks with both the capacity and incentive to lend. [15] [16]

8. There is a worry that the failure to raise requisite funds will send a negative signal to the marketplace. I am not so sure that that is a bad thing. A lack of capital should send a negative signal. But if the view is that such a signal would be too costly, then the government could propose a compulsory recapitalization program for all banks which are found short of the requisite capital, with, say, 50% of the funds provided by TARP, and the rest raised from the private sector. Any bank unable to raise the requisite capital would be taken over entirely by the government. (If, at the time of examination, any bank is found to have negative

[15] Lack of transparency in TARP makes it difficult to know precisely the principles that guided the allocation of funds, but it does not appear that there was an explicit attempt to ascertain the size of the hole in the balance sheet and to repair it. There are difficult problems in ascertaining the size of the hole (in valuing net worth), given the complicated interdependencies arising out of holdings of derivatives with counterparty risk.

[16] The current game of sequential ad hoc bail-outs is particularly problematic. Because those who survive are becoming ever bigger, increasingly too big to fail, they may demand better terms with the government. Thus, it may pay each to try to wait it out, to see if they can survive. Citibank seems to have done better for itself than Bear Stearns. Would JP Morgan or Goldman Sachs do even better, if they now need a bail-out?

net worth, then the bondholders should be forced through debt equity swaps to bring the firm's capital back above zero, with the offer of 50% equity injection from TARP to bring the capital up to the requisite level applying thereafter.)

9. If the government is providing capital, it must have a voice, in the form of board seats at the very least, to make sure that no action is undertaken that would dilute the government's interest or circumvent commitments to good lending and corporate governance practices.[17] We should recognize that the mixture of government funding (including through explicit or implicit guarantees) with private profit maximization is fraught with difficulties. The private sector will maximize its own interests, leaving the government bearing undue risk. This is especially true of all the banks in the TARP program because they present systemic risks; they are too big to fail, presenting perverse incentives.

10. Government guarantees or relending through private firms may make little sense, unless very carefully designed. The government bears the risk. All the bank is doing is providing some transaction services, at a relatively high cost. The higher costs impede the flow of credit, increase the risk borne by the government, and lower the returns that might be received by the government. Earlier experiences with education loans and mortgages suggest that the government can perform these services just as or more efficiently than the banks—it would be hard for the government to perform worse than the private banks have done.

11. More of the money should go to stemming the flood of foreclosures, through one of the reform measures discussed elsewhere.

12. Government guarantees can help the TARP money go further, but (as discussed earlier) face a number of difficulties: ascertaining the appropriate risk premium is difficult, charging inappropriate risk premium may expose the government to undue risk and can be highly distortionary, and the implicit subsidies and transfers are often very non-transparent. To the extent that such guarantees are used, there needs to be especially careful oversight.

13. There are, in addition, critical procedural reforms that should be considered. The most important is to take the administration of TARP out of the Treasury and create an independent agency, with oversight from all sectors of the economy, not just from finance. The objective should be macro-economic impact. Those in the real sector (workers, construction) will have an incentive to make sure that that is the case. Decisions within Treasury may be subject to political influence or to the perception of political influence. This is particularly important given the lack of transparency and the ad hoc nature of the program so far. The government has

[17] It is widely recognized that undercapitalized banks may engage in excessive risk taking. But government provision of capital does not fundamentally change incentives. Unless they take over control of the bank, the *incentive* effects are limited, or may even be perverse. The original owners only worry about the loss of their own capital, not the capital provided by the bank. All the government is doing is providing up front some of the money that it would have provided in the event of a crisis.

been picking winners and losers. Many, both inside and outside the financial market, worry about how those decisions have been made. What is clear is that there have been big winners and big losers. The government has never made it clear who these winners and losers are and has made no attempt to recover for the taxpayers some of the gains that have accrued to the winners (e.g., the AIG bail-out was also a bail-out of those who would have lost large amounts had AIG failed. American taxpayers have a right to know who these indirect beneficiaries are. How did that influence the decisions that were made?)

14. We need far more transparency in the transactions. A transaction between the U.S. government and a bank is not like a commercial transaction between two parties. Citizens have a basic right to know. There should be a low threshold for secrecy; and if an argument can be put for secrecy, even then there must be full disclosure to an oversight panel.

Professor WARREN. Thank you, Dr. Stiglitz. Mr. Sumerlin.

STATEMENT OF MR. MARC SUMERLIN, MANAGING DIRECTOR AND CO-FOUNDER, THE LINDSEY GROUP

Mr. SUMERLIN. Madam Chair, Members of the Panel, thank you very much.

My name is Marc Sumerlin. I'm Managing Director of The Lindsey Group, an economic consulting firm. Previously, I was Deputy Director of the National Economic Council in 2001 and 2002.

We are in the midst of an economic contraction that is currently mirroring the worst months of the 1974 recession, one of the sharpest post-World War II periods of decline for our country. Despite all of the actions to date, it has been impossible to completely stop the deterioration because the economy is deleveraging and in fact needs to shed leverage after a decade of excessive borrowing.

Credit market liabilities in the United States soared from 250 percent of GDP in 1997 to 350 percent of GDP in 2007, reaching over $50 trillion. Over this time, the economy has suffered from the rapid deflation of two asset bubbles. While both consumers and the financial sector still need to reduce their debt burden, a central goal of the emergency policies has been to slow the pace of deleveraging to minimize the negative feedback loops that occur during a sharp economic downturn.

The goals of longer-term reform strategies are quite different and should focus on preventing excessive leverage from happening in the next cycle. In thinking about reform of the regulatory structure, I believe it is imperative to consider the proper role of monetary policy as well.

In my written testimony, I have described in detail where I believe policy across government failed in the past. Now, I'd like to focus on three broad recommendations, all centered on preventing excessive leverage from building up again.

The first recommendation is for the Federal Reserve to take a more active role in preventing asset and credit bubbles from forming in the first place, as I believe is mandated under the Federal Reserve Act.

During the 1990s, there emerged a widespread belief that central bankers had learned from their inflationary mistakes of the past and that another end-of-history moment had arrived where everyone could relax or at least prosper.

There was a new consensus view that monetary policies should effectively target a low level of goods and services inflation while ignoring asset prices, except to the extent that they signal a change in future inflation. Not only would asset bubbles in credit not be resisted but policymakers believed they should aggressively lower interest rates after an asset bubble pop to mitigate the damage. This created an asymmetric bias that traders referred to as the "Greenspan Put." This bias towards easing monetary policy also created a bias towards over-valued assets that would eventually collapse under their own weight. In fact, financial bubbles are dependent on an accommodative monetary policy in the first place.

The Federal Reserve needs to take a more active role in promoting financial stability. While the Fed has from creation adopted the lender of last resort role, it has not always embraced the policy of mitigating boom-bust cycles in asset prices, but under the Federal Reserve Act, the Central Bank is obligated to "maintain long run growth of monetary and credit aggregates commensurate with the economy's long-run potential to increase production."

This gives the Federal Reserve a responsibility to prevent asset bubbles since they are fueled by excess credit.

The second recommendation is to shift housing policy from subsidizing leverage to promoting equity, as the Central Bank was not the only part of government that was complicit in the housing and credit bubble.

Government housing policy has been designed to directly subsidize leverage. The most expensive housing policy the U.S. has is the tax deduction on mortgage interest payments, which lowers borrowing costs. This is why realtors commonly refer to your interest payments as your "tax deduction."

Both the Clinton and the Bush Administration have pushed various programs that supported easier access to housing credit and lower downpayments which, by definition, create leverage. At the same time, the private sector seemed determined to outdo the government's lead at the peak of the bubble.

In 2005, a remarkable 43 percent of all first-time homeowners put zero down or took out a mortgage in excess of the value of the home. It's worth emphasizing here that buying a house without a downpayment is not homeownership. It is renting with risk. To the extent possible, government subsidies to leverage should be replaced with broader programs that help build equity, such as downpayment matches for new homeowners.

My last recommendation is to support a binding limit on the amount of leverage that is permitted by banks and other financial institutions that act as banks. A large part of the financial system, most notably commercial banks, under the regulation of the FDIC, already has a limit on their leverage. These banks are subject to a simple leverage ratio that caps their assets relative to their capital. Notably, investment banks were not subject to this limit.

For covered banks, if the leverage ratio drops below four percent, the FDIC must start supervisory intervention and if the leverage ratio drops below two percent, the bank is considered critically undercapitalized and is shut down. This system means that any bank that is leveraged more than 25:1 will be under intense regulatory scrutiny. Banks hate these simple calculations because they cannot easily be skirted, which is the very point.

It is worth remembering that banks are inherently risky entities. John Maynard Keynes once quipped that "a prudent banker is one that fails at the same time that all other bankers fail." But this inherent riskiness is why banks need more limits in other parts of the economy.

A binding leverage ratio is a simple, transparent, and blunt form of regulation, all attributes that could make it a useful form to bank regulators around the world.

Professor WARREN. Mr. Sumerlin, could I just ask you to finish? You're over time.

Mr. SUMERLIN. Absolutely. The last point I would make, adding to that, is at the same time, all efforts have to be made to move off-balance sheet activity back on balance sheet, as will soon be required under FAS–140, and I'd just like to make one more note, that both the housing and credit bubble were exacerbated by the psychology of a bull market, which is important to always keep in perspective, which adversely affected the judgment of homebuyers, market participants, and regulators.

Thank you very much.

[The prepared statement of Mr. Sumerlin follows:]

Improving Financial Stability

Testimony before the Congressional Oversight Panel

Marc Sumerlin

January 14, 2009

We are in the midst of an economic contraction that is currently mirroring the worst months of the 1974 recession, one of the sharpest post-World War II periods of decline for our country. While the current recession started at the end of 2007, the economy effectively fell off a cliff in late September after the failure of Lehman Brothers and the subsequent warnings of U.S. leaders that we were on the verge of a financial panic. In our system of government, these public warnings were necessary to build support for funding a broad emergency program, in this case the Troubled Assets Relief Program. However, the creation of the TARP proved insufficient by itself, and it was not until the Treasury added capital injections to the original plan and until the FDIC agreed to temporarily guarantee certain bank debt and provide unlimited deposit insurance on transaction accounts that some modicum of financial stability was achieved.

It has been impossible to completely stop the deterioration because the economy is deleveraging, and in fact needs to shed leverage after a decade of excessive borrowing. Credit market liabilities in the U.S. soared from 250 percent of GDP in 1997 to 350 percent of GDP in 2007, reaching over $50 trillion. Over this time the economy has suffered from the rapid deflation of two asset bubbles. While both consumers and the financial sector still need to reduce their debt burden, a central goal of the emergency policies has been to slow the pace of deleveraging to minimize the negative feedback loops that occur during a sharp economic downturn. So far troubled banks have received help restoring their capital and protecting their liabilities. But bad assets still remain on their balance sheets and are a drag on their ability to function. Immediate future actions should consider ways to remove the bad assets, either through the creation of a "bad" bank as has been done in other countries, or through direct purchases of these assets. I'll note that the private sector is starting to make some progress in establishing a market for certain types of troubled assets. Other actions should focus on making a concerted effort to stabilize the housing sector, the source of much of the pain.

The goals of longer-term reform strategies are quite different and should focus on preventing excessive leverage from happening in the next cycle. In thinking about reform of the regulatory structure, it is imperative to consider the proper role of monetary policy as well. I will describe in some detail where I believe policy across government failed in the past. I will then conclude with three recommendations, all centered on preventing excessive leverage from building up. The first recommendation is for the Federal Reserve to take a more active role in preventing asset and credit bubbles from forming in the first place, as I believe is mandated under the Federal Reserve Act. The second recommendation is to shift housing policy, when possible, from subsidizing leverage to promoting equity. The third recommendation is to support binding limits on the amount of leverage that is permitted by banks and institutions that function as banks.

What Happened

From 1984 to 2006, the economic performance of countries around the world, both in terms of the stability of growth and inflation, improved substantially compared with the 1970s.[1] Economists deemed this period of relative tranquility the "Great Moderation." The peak for the Great Moderation can be pegged to January 2007, just before HSBC's mortgage problems were revealed and New Century Financial buckled, a time when complacency was at an all time high. Credit spreads around the world had collapsed – even spreads on Ecuadorian bonds barely budged when the President hinted at a default in late 2006. Credit was more than just acceptable, it had become fashionable.

There was a belief that monetary policy had finally learned from the past. Policymakers from the 1970s had overestimated their ability to control output and underestimated their ability to *cause* inflation. But now that central bankers had learned from that experience, another "end of history" moment had arrived where everyone could relax, or at least prosper. Little did central bankers know that they were making similar-sized errors. Reduced volatility had meant easier planning, reduced hedging costs, and reduced uncertainty in the short run. But there was a flip side; perhaps the biggest asset and credit bubble in history was being created.

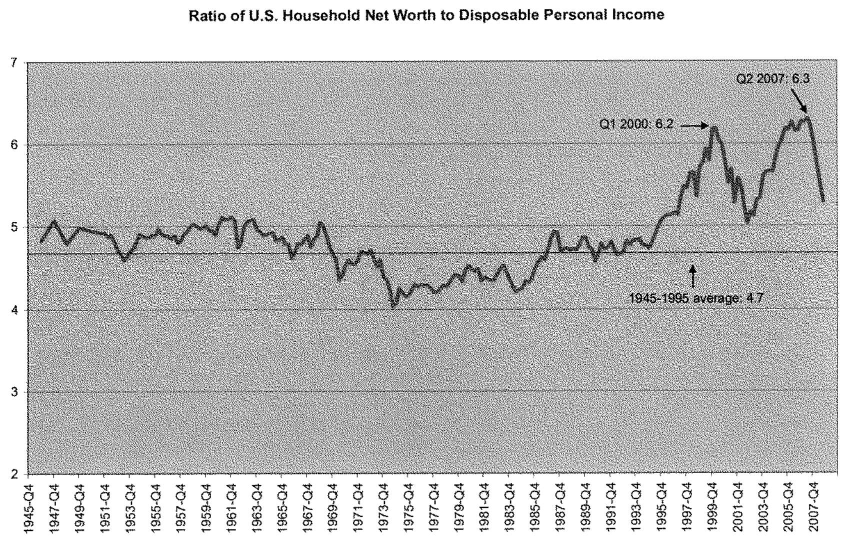
After peaking in value on October 3, 2007, the value of global equities was cut in half from $62 trillion to $31 trillion one year later, a global stock market crash not seen since the 1929-1932 decline. Over the same period, credit spreads have soared. The spread between emerging market sovereign debt and U.S. government debt has risen from a low 1.50 percent in June of 2007 to 8.65 percent in October 2008. Most of the damage in markets occurred after Lehman Brothers, a financial institution that had been around for 150 years, failed. In retrospect, Lehman Brothers was too big to fail and policymakers did not realize it at the time. The events that unfolded since then have now called into question the success of the last 25 years. This is an extraordinary crash, and one that is no way consistent with a placid label like the Great Moderation. Even a cursory look at the U.S. stock market shows that in the last thirteen years we have been in a boom/bust cycle of rapidly increasing and then deflating asset prices, hardly a period of moderation. The S&P 500 rose from a value of 500 in 1995 to a remarkable 1550 in 2000, only to fall to below 800 by 2002. It then rose back to its previous high of 1550 in 2007 before collapsing back to 800 again in 2008.

[1] See for example "The Great Moderation," Governor Ben Bernanke, February 20, 2004.

The Fundamental Mistake of Central Banks

When history takes stock of this financial panic, much blame will be allocated to central bankers who believed that asset prices could be in large part ignored when making policy decisions. There were a number of components to this critical belief, all of them wrong. One component was the belief that an appropriate judgment about the level of asset prices cannot be determined in advance, or at least not one that is better than the market's. But, practically every variable a central bank uses to formulate monetary policy is unknowable, including its forecast for GDP and inflation. Former Federal Reserve staffer Steve Cecchetti has argued that assessing a misalignment in asset prices is not any more difficult than assessing a key input like the output gap (in simple terms, the output gap is the difference between actual and trend growth).[2] In fact, the output gap is routinely used by central banks to base policy on, even though it is impossible to observe in real life ever. So assessing assets prices, at least when they make extreme moves, is probably easier than other key judgments a central bank makes on a regular basis. One simple way to do this is to look at the historic ratio of net worth to disposable personal income in the United States, as shown in the chart below. The value of assets (and net worth) is ultimately dependent on the income of people who purchase these assets. For most of recorded history, this ratio was between four and five. There are two sharp deviations, the technology bubble in late 1990s and the more recent housing bubble. These were hardly undetectable deviations.

[2] Cecchetti, Stephen, Genberg, Hans, and Wadhwani, Sushil, "Asset Prices in a Flexible Inflation Targeting Framework," 2002.



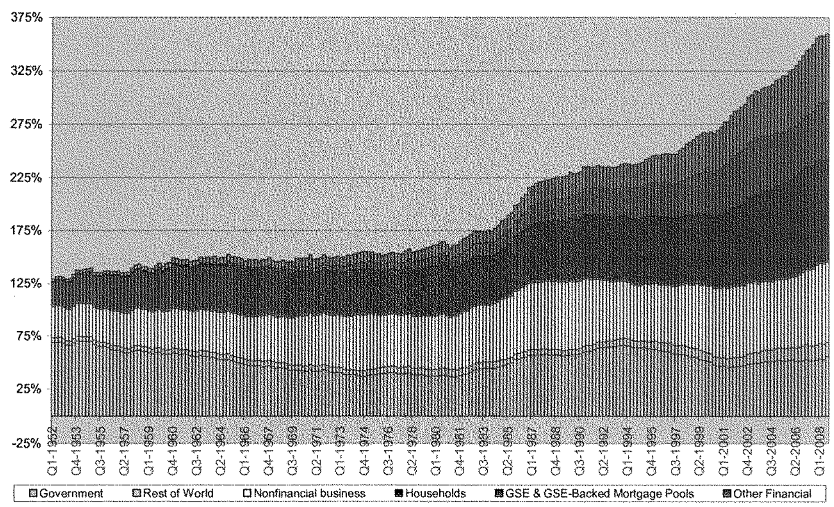
Source: Federal Reserve Flow of Funds, The Lindsey Group

Not only did central bankers believe that asset-bubbles were undetectable, Alan Greenspan argued strenuously that the best policy was to let them pop and then mitigate the damage by cutting rates. This created an asymmetric bias towards easy rates, a bias that traders referred to as the "Greenspan Put." Rising asset prices would not be resisted and falling asset prices would be cushioned with a vigorous policy response. This bias toward easy monetary policy also created a bias toward overvalued asset prices that would eventually collapse under their own weight.

Attention from the emerging U.S. stock market bubble was diverted by the 1997 Asian financial crisis and the associated Russian debt default of 1998, which sunk the mammoth hedge fund Long Term Capital Management. These events are directly relevant to the most credible argument put forth in defense of the Federal Reserve's policy on asset prices, and that is the notion of the Global Savings Glut. During the mid 1990s, a number of Asian economies like South Korea and Thailand were growing so fast that they started overheating. This overheating led to a rise in inflation and in the real value of their currencies. As their currencies appreciated, the countries started to run current account deficits that ultimately became unsustainable. Finally, in July 1997, the Thai Bhat came unpegged, setting off a global currency crisis that reverberated for over a year. The result was that these nations developed a new conviction, aided by markets, to run current account surpluses rather than deficits, joining traditional export powerhouses like Japan and Germany. Then in 2001, China joined the WTO and within a few years it was running a massive current account surplus as well.

By definition, current account surplus countries are savers that must be offset by current account deficit countries. Borrowing countries like the United States, the United Kingdom, Spain, and Australia ran enormous deficits at the same time, sucking in capital from around the world. Proponents of the Global Savings Glut theory, most prominently Chairman Bernanke, argue that this huge supply of capital led to lower global rates. Former Fed Chairman Greenspan noted that low rates were a global phenomenon, and that the Federal Reserve had little control over domestic long term rates in this environment. The low rates caused a global housing boom that was in no way a U.S.-specific event. Housing prices did in fact boom all over the world, with countries like Spain and Ireland experiencing price gains well in excess of the gains in America. Interestingly, the rise in the amount of credit market liabilities in the U.S. began to significantly outpace the rise in GDP starting in about 1997, at about the same time that the global savings glut started.

Credit Market Liabilities to GDP



Source: Federal Reserve Flow of Funds, The Lindsey Group

Still, policymakers in the U.S. did little to lean against the global winds. The rise in the stock market was celebrated even as the P/E ratio of the S&P rose to a staggering 44, three times its historic average. The failure of policymakers at the central bank and elsewhere to lean against a developing asset and credit bubble was their biggest mistake. While stocks were rising, American corporations took on enormous debt to invest in the "new" economy. Once the technology bubble was allowed to start, the boom bust cycle that has lasted over a decade was on its way.

All throughout this time, central bankers pointed out that inflation was low and stable. Another fundamental error of monetary experts was the emerging consensus of inflation targeting.[3] Inflation targeting holds that central banks should target a specific numeric value of goods and services inflation, and that central banks should ignore asset prices except to the extent that they signal changes in future goods and services inflation. Among inflation targeters, a further consensus was reached that goods and services prices should always rise between zero and two percent. Deflation, or an outright fall in prices, was deemed especially dangerous, and for some good reasons. With prices falling, central banks lose the ability to reduce the real interest as much as they can when prices are rising. For instance, if deflation is running 2 percent a year and the nominal interest rate is zero, then the real rate is still a positive 2 percent and is difficult to lower because of the zero bound on the nominal rate. Deflation also increases the real value of debt, making it a dangerous condition for economies that are in trouble. But there was a weakness in the consensus argument that was underappreciated. Prices can fall for multiple reasons. "Bad" price falls occur when demand is weak or when the money supply (or velocity) is restricted. This is the type of deflation that happened at the onset of the Great Depression and is indeed a dangerous event. But, prices can also fall because of technological improvements. This is the type of deflation that happened in the late 1990s in the computer industry. If aggregate demand is strong and an economy is experiencing a positive and widespread fall in goods and services prices, monetary policymakers should not fear an overall inflation rate that falls below zero for a time. Equally important, they should not be comforted if inflation is merely low in such times. Inflation targeting was in part based on the belief that stable prices would increase the efficient allocation of resources. But during the technology bubble and during the housing bubble, a low inflation rate was not enough to stop a misallocation of capital.

By March of 2000, the stock market had finally peaked and it began a long slide, ultimately losing nearly half of its value by spring of 2002. In the U.S., $5 trillion of wealth was lost and businesses were shedding costs by laying off workers and cutting investment spending. The economy contracted in third quarter of 2000, in the first quarter of 2001, and in the third

[3] Greenspan was a noted exception to those who favored a public inflation-target. But achieving price stability as measured by the core PCE price index remained a central objective of his.

quarter of 2001. During this last quarter, the terrorist attacks on September 11 induced a shock to confidence. The Bush Administration adopted a strategy of propping up after-tax income as a way of supporting consumer spending. Business balance sheets were in rough shape and needed repair. A contraction by both business and the consumer at the same time could have resulted in a self-reinforcing downturn. As a result taxes were cut three times, in June of 2001, in March of 2002, and in May of 2003.

At the same time, the Federal Reserve was adopting an aggressive monetary response, with rates cut 11 times from January to December of 2001. With the economy slow to respond, the Federal Reserve cut sporadically in 2002 and 2003, until the Federal Funds rate was reduced to 1 percent. To spur the recovery and add predictability, the Federal Reserve choose a strategy of pre-announcing that rates would be kept low for "a considerable period." And when the Fed finally started to raise rates in the summer of 2004, it choose to announce that the rate of increase would take place "at a measured pace."

The popping of the technology bubble did start a more vigorous debate about whether a central bank should pay more attention to asset prices. In 2002, Michael Bordo and Olivier Jeanne directly questioned the Federal Reserve's current view of asset prices, which they called benign neglect.[4] During the same year, Chairman Greenspan argued that rise in the interest rate that would be needed to stop a bubble would be sizable and disruptive to the economy. But Bordo and Jeanne countered that during exceptional rises in asset prices, central bankers must tighten policy more than they otherwise would.

Bordo and Jeanne pointed out that financial crises are endogenous to monetary policy, and that they are dependent on an accommodative monetary policy in the first place. Given this, they argue, a preemptive restriction of monetary policy can be thought of as insurance against the risk of a credit crunch. In their view, estimating the risk of an asset price bubble and the proper level of insurance to take out must ultimately be based on judgment and cannot be estimated by any simple rule. The amount of proactive monetary policy depends on the amount of risk in the balance sheets of the private sector. During a boom period, the private sector accumulates a high level of debt. When asset prices fall during the bust phase, the collateral behind the debt shrinks, impeding the ability of the private sector to finance their operations. The link between private sector balance sheets and financial stability are inherently non-linear. Monetary policymakers have little choice but to make an assessment about both the cost and likelihood of an extreme event happening. Bordo and Jeanne end their 2002 paper with a very prophetic summary:

> "The recent literature on monetary policy may give the impression of having reached an 'end of history' based on a consensus on the desirability of simple

[4] Bordo, Michael D. and Jeanne, Olivier, "Monetary Policy and Asset Prices: Does "Benign Neglect" Make Sense?" October 2002.

rules, with the main remaining object of debate being the precise form of the golden policy rule. Like all 'ends of history', this one must have its Achilles heel, and we would surmise that it has to do with the relationship between monetary policy and financial stability."

While the new debate was underway, the economy finally turned up. Nearly every macroeconomic variable started to improve in July of 2003, by coincidence or design at the exact time that the full marginal tax rate cuts took effect. Growth in the third quarter of 2003 was a powerful 7.5 percent. Proof of the expansion was the drop in the unemployment rate, which fell from 6.3 percent in June of 2003 to 4.4 percent in the fall of 2006. Conventional wisdom was that monetary policy could remain stimulative until slack in the labor market was removed -- commonly represented by an unemployment rate below 5 percent, which did not happen until late 2005. But, as it turns out, there was more to worry about than just labor market slack.

The Fed's easy money policy was having an impact beyond employment. For three straight years, 2002, 2003, and 2004, the real Fed Funds rate (the overnight rate less a measure of inflation) was negative. Negative real interest rates are the equivalent of free money. A number of economists warned frequently that this easy money was causing dangerous distortions. Even when the Federal Reserve started to raise rates, it telegraphed that rates would only go up gradually. This predictability helped to lower forward bond volatility and future borrowing costs. As interest rate volatility declined, credit spreads tightened and FX volatility declined. Ironically, traders, pension funds, and insurance companies had to put on more risk to attain their yield targets.

The most obvious distortion of easy money was the rapid growth of credit. Banks and hedge funds could borrow at low overnight rates and invest in virtually any product in the world with a higher yield. Traders call this rate differential positive carry, and low rates in the U.S., and in Japan, encouraged investors around the world to put on carry trades. (When yachts start showing up with names like "Positive Carry," the borrowing has probably got a bit excessive.) With the Federal Reserve pre-announcing its strategy, it was believed that there would be ample time to get out of carry trades when the time came. No skill or analysis was needed, and the best investors in the world started to be equaled or surpassed by those with lesser analytical abilities. The best measure of this trade is to look at a wide variety of credit spreads, or the difference in yield between safe and risky assets. Spreads from almost every credit class collapsed as investors played the yield curve. But so long as inflation in goods and services remained low, central bankers worried little about the credit creation associated with lower and lower rates.

Policymakers also advocated another belief that was bizarre: financial innovation could lower the aggregate amount of risk in the economy. For instance, in 2005 Alan Greenspan offered this comment on the proliferation of derivatives (while also warning they should be used appropriately):

> "The use of a growing array of derivatives and the related application of more-sophisticated approaches to measuring and managing risk are key factors underpinning the greater resilience of our largest financial institutions, which was so evident during the credit cycle of 2001-02 and which seems to have persisted. Derivatives have permitted the unbundling of financial risks. Because risks can be unbundled, individual financial instruments now can be analyzed in terms of their common underlying risk factors, and risks can be managed on a portfolio basis. Partly because of the proposed Basel II capital requirements, the sophisticated risk-management approaches that derivatives have facilitated are being employed more widely and systematically in the banking and financial services industries."[5]

The rapid growth in the finance area, both in terms of products offered and profits collected, was widely seen as risk reducing. Not everyone saw it that way. Professor Joseph Mason of Drexel University aptly pointed out that "securitization can't make risk go away, but it can cause it to get lost."[6] At its root, macroeconomic risk is derived from human behavior. Greed causes humans to overreach and fear causes them to pull back. Financial innovation can transfer risk to stronger hands, to put it in Wall Street parlance from the Great Depression days, but it does not make risk go away.

The best proof of this is the credit default swap, which grew from a non-existent market in the 1990s to a $60 trillion market (gross notional value) at its peak in 2007. Credit default swaps are contracts that shift credit risk from a lender to a third party. Before credit default swaps, a buyer of General Motors bonds would receive a higher interest rate compared with a safe bond like a U.S. Treasury primarily because the General Motors bonds had a higher possibility of default. But with an active CDS market, an investor could buy the General Motors bond, receive the higher interest rate relative to a Treasury, and purchase default risk protection from a CDS. To make the trade work, the protection had to cost less than profit made on the spread, at least until this was arbitraged away. This innovation made all forms of credit risk much more attractive, especially in a period of falling default rates, and in this example, lowered the spread that General Motors had to pay on its bond. But note that this transaction did nothing to lower the probability that General Motors might default some day. And if GM defaulted, the economy would suffer the same economic loss. Perhaps it would fall to stronger hands, but with credit default swaps we aren't completely sure. *The Economist* reported, based on data from CreditSights, that 32 percent of CDS protection in 2007 was sold by hedge funds.[7] Hedge funds

[5] "Risk Transfer and Financial Stability," Alan Greenspan, May 5, 2005.
[6] "Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions," Mason, Joseph, and Rosner, Joshua, Hudson Institute, February 3, 2007.
[7] "Briefing: Credit Derivatives," the Economist, November 8, 2008.

are not natural providers of insurance since they have no requirement to reserve against their commitments.

Not everyone saw this increase in financial activity so sanguinely. The Bank of International Settlements, which serves almost as a central bank to central banks, was an avid critic of the conventional wisdom. In a speech in 2004, BIS chief economist William White outlined how it could all go wrong:

"One possible set of interactions is the following:

- Lower policy rates enhance the search for yield;
- This leads to more risk-taking and under-pricing of risks;
- Safety nets enhance this trend, as does pressure for increased shareholder value;
- Lower credit costs encourage 1) debt accumulation, 2) asset price increases, 3) overinvestment;
- Debt buildups feedback on the economy and potentially the health of the financial system (if financial "buffers" not big enough);
- This raises (perhaps sharply) the price of risk, and everything goes into reverse with implications for the real economy; growth, jobs, inflation/deflation.

Given developments over the last few years, and even the last few months (as spreads have declined sharply, for sovereigns in particular but also high-yield and syndicated loans), attempts to either support or dismiss such stories take on special and very practical significance for central bankers in particular. This is all the more the case since empirical evidence indicates that joint credit/asset price 'booms' do have predictive power for 'busts' over horizons of 1-4 years, and we suspect implications for defaults and default correlations as well."[8]

So, not only was risk not being reduced, it was being increased dramatically. Borrowing standards were being lowered across the board, and this erosion in diligence was most notable in housing. By 2006, 40 percent of all new mortgages in the U.S. were either subprime or Alt-A. Subprime lending is to borrowers who have already proved themselves to be unreliable. Alt-A loans are products with at least one exotic feature, most commonly a no documentation or low documentation loan. Loans were given to these borrows because default rates were dropping rapidly, and because Wall Street was demanding new mortgages. But default rates were only dropping because home prices were rising rapidly. Who would default when they could sell their home for more than they paid? The lax lending wasn't confined to housing. Covenant-light loans were becoming industry standard for large swathes of the credit industry.

[8] "The Pricing of Credit Risk," Keynote presentation by William R White, Economic Adviser, Bank for International Settlements, at the Workshop on Pricing of Credit Risk, Basel 9-10 September 2004.

As a result, leverage in the entire economy increased. At the end of 2007, credit market liabilities in the U.S. were $50 trillion, 3.5 times GDP (see chart on p. 5). This was well in excess of the 2.5 ratio that existed in 1997 before the start of the long housing boom and the advent of the global savings glut that allowed America to borrow from abroad. Late 2006 represented the peak for the current account deficit, at about 6 percent of GDP and $800 billion in annual borrowing from abroad. But by early 2007, the air was starting to come out of the housing bubble, and once prices started to fall, they can plummet. The best measure of home prices, the Case Shiller National Home Price index, was down 23 percent from June of 2006 to September of 2008. With housing inventories still high, especially of vacant homes, prices are still falling. They will continue to fall until the inventories start to clear at a decent rate.

The broader consumer spending and debt bubble is also unwinding now, albeit with a lag. From 1981 to 2007, consumer spending as a share of GDP rose from 62 percent to 71 percent as consumers borrowed more for everything. By 2007, the bottom half of the country had virtually no liquid savings. The median amount of liquid assets – checking, savings, and money market accounts – was only about two weeks of income. The average car was purchased with only 5 percent down. And it was not uncommon for middle income Americans to be carrying five or more credit cards in their wallet. The result of this credit unwind is a U.S. economy that has fallen into a steep recession as the savings rate finally started to rise. With stronger financial linkages than ever, the rest of world entered a steep downturn as well, with the severest outcomes most likely in the other borrowing countries like the United Kingdom, Spain, and Australia. But exporters like Germany, Japan, and China were living off the consumer bubbles in other nations and were not immune from the fall.

The Fundamental Mistake of Housing Policy

Central banks were not the only part of government that was complicit in the housing and credit bubble. Government housing policy was directly subsidizing leverage. The biggest housing policy the U.S. has is the tax deduction on mortgage interest payments, which lowers borrowing costs. For instance, assume you and your spouse are going to purchase a $300,000 house and earn a combined $100,000 a year. If you put half down, your interest payments in your first year will approximate $9,750 with a 6 ½ percent mortgage. This would generate a tax savings of almost $2,500 through the home mortgage deduction. But if instead you decide to put zero down, your first year mortgage interest payments come to about $19,500, generating an annual tax deduction of almost $5,000. This is why realtors commonly refer to your interest payments as your "tax deduction." They are right in one respect, the higher your down payment, the lower your tax benefit, exactly the opposite of what government should encourage.

The government also subsidized leverage through the government sponsored housing entities, Fannie Mae and Freddie Mac. One of the direct goals of the GSEs was to insure mortgages from default, lowering mortgage rates and again borrowing costs. They were able to operate with scale primarily because of their association with the federal government. As we now know, their ability to privatize profits and socialize losses encouraged them lever up on an enormous scale. At the time of their failure, the two GSEs had balance sheet assets of $1½ trillion and off-balance sheet guarantee exposure of $4 trillion. Their true capital was close to zero. Before their takeover by the government, they had become aggressive players in both the Alt-A and subprime mortgage space. Peter Wallison and Charles Calomiris calculate that Fannie Mae and Freddie Mac had $1 trillion of subprime and Alt-A investments at their time of takeover, almost all of which were added to their single family book of business between 2005 and 2007.[9] By encouraging loans to people who could not afford them, the GSEs were helping to destabilize the housing market, in direct contrast with their mission.

But housing credit standards had been eroding for at least a decade. One important turning point was the year 1995. The Clinton Administration embarked on a major policy, the National Homeownership Strategy (which led to the creation of the National Partners in Homeownership), designed to increase homeownership rates by encouraging broader financing among other things. At the same time, the Federal Reserve issued new regulations under the Community Reinvestment Act that, in the words of the Federal Reserve Governor who wrote the regulations, set up soft quotas on lending in underserved areas. Another quasi-government agency, the public-private Neighborhood Reinvestment Corporation, also helped set the stage for higher leverage in the housing industry. In 1995, it adopted a model down payment program with a 5 percent standard at a time. The Chairman of the Neighborhood Reinvestment Corporation is by tradition a Federal Reserve Governor, which effectively puts the government stamp of approval on any program. These relaxed standards, combined with a growing economy, allowed the underpinnings of the housing market to begin to erode. Housing analyst Josh Rosner document the broad decline in his 2001 market report:[10]

> "Traditionally, homebuyers were required to put a significant amount of money 'down' as payment for a home. Traditionally this amount was usually 20% of the home's 'value'. Down payments assured lenders that buyers had enough of a personal investment in the property to repay the debt. Homeownership in the United States had always been something for which people saved...
>
> The requirement that homebuyers make significant down payments was eliminated in the 1990's. The National Partners in Homeownership (NPH) urged

[9] Wallison, Peter J. and Calomiris, Charles W., "The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac," September 2008.
[10] Rosner, Josh, "Housing in the New Millennium: A Home Without Equity is Just a Rental With Debt," GrahamFisher, June 29, 2001.

> and approved increasingly larger reductions in requirements. 'The partnership should support continued federal and state funding of targeted homeownership subsidies for households that would not otherwise be able to purchase homes. Notwithstanding the growing number of high loan-to-value mortgage products available today, many households, particularly low- and moderate- income families, will need subsidies to supplement down payment and closing funds or to reduce the monthly obligation on a home purchase mortgage'. 'In 1989 only 7 percent of home mortgages were made with less than 10 percent down payment. By August 1994, low down payment mortgage loans had increased to 29 percent'. This trend continued unabated throughout the 1990's so by 1999, over 50% of mortgages had down payments of less than 10%. In 1976 the average down payment by first time homebuyers was 18%, by 1999 that down payment had fallen to 12.6%. In 1999, more than 5% of all residential mortgages had no equity or had negative home-equity. Eliminating down payment barriers has created a homeownership option for Americans who previously were forced to rent, due to savings or credit issues.
>
> Over the past decade Fannie Mae and Freddie Mac have reduced required down payments on loans that they purchase in the secondary market. Those requirements have declined from 10% to 5% to 3% and in the past few months Fannie Mae announced that it would follow Freddie Mac's recent move into the 0% down payment mortgage market. Although they are buying low down payment loans, those loans must be insured with 'private mortgage insurance' (PMI). On homes with PMI, even the closing costs can now be borrowed through unsecured loans, gifts or subsidies. This means that not only can the buyer put zero dollars down to purchase a new house but also that the mortgage can finance the closing costs."

The Bush Administration continued the push to expand home ownership, and in 2002 President Bush adopted a specific goal of increasing the number of minority homeowners by 5.5 million by the end of the decade. The Federal Housing Agency had also lowered their standards and required only a 3 percent down payment to receive a government-backed FHA loan, and even this could be paid by a third party. As the housing sector started to pick up strength on the back of low interest rates and the 2003 turn in the macroeconomy, the government pushed for even easier standards. On January 19, 2004, President Bush proposed eliminating the FHA's paltry 3 percent down payment with his "Zero-Downpayment Initiative," which would have allowed 150,000 people in the program's first year to take an FHA loan with no money down.[11] While this proposal was not enacted, the private sector had long been following the government's lead and, in this bull market, was determined to outdo it. Rapidly rising home prices would make zero down loans available on a massive scale. By 2005, a remarkable 43 percent of all first time homeowners put zero down or took out a mortgage in excess of the value

[11] "Bush Administration Announces New HUD Zero Down Payment Mortgage," HUD press release January 19, 2004.

of the home. If home prices were rising 10 percent a year, a zero down loan would gain a 10 percent equity stake in just 12 months. Or so the logic went.

It's worth emphasizing here that buying a house without a down payment is not home ownership. It is renting with risk. Leverage is an old enemy, and when prices turn down, it can act viciously. If you bought with zero down in 2006, by the end of 2008 you were likely to be underwater by 20 percent. For someone who originally bought a house at four times income, this loss would amount to more than a year of take-home pay, providing a powerful incentive to hand in the keys and walk away. Of course, these people are also to blame. Anyone who forgot all reasonable standards of restraint and rushed to buy is not without fault.

The government also failed in its duty to regulate against egregious actions by the mortgage originators. It wasn't until March of 2007 that the Federal Reserve and other bank regulators issued rules against subprime mortgages that had teaser rates with a large interest rate hike built in. The regulatory action came a full two years after the bad loans were embraced by mortgage originators in volume, and literally simultaneously with the private sector finally reigning itself in.

The Fundamental Mistake of the Private Sector: Trying to Capitalize on Two Government Mistakes

The macroeconomic tilt created by policymakers clearly had a bias toward higher asset prices and more leverage. Rather than pushback, the private sector did its best to reap profits from the system and along the way developed processes with serious incentive problems. Perhaps the biggest sin of the private sector was letting the securitization process distort the traditional creditor/debtor relationship. In the old days, a bank made a loan and kept the loan on its books. This provided a strong incentive to know your borrower and to adequately check his or her ability to repay. The downside to this system was that banks ended up with a regional concentration of mortgages, and were therefore subject to regional housing busts like the ones that occurred in California, Massachusetts, and Texas. Securitization allowed the loans to be immediately sold to a secondary market, in effect nationalizing the housing market, but also providing less incentive for a bank to check the creditworthiness of the borrower. But in the early days of securitization, the packagers were still careful about the mortgages they would allow into the security pools. By the mid 2000s, in the heat of the boom, packagers demanded more and more product, and mortgage securities were being passed around like a game of hot potato. Mortgages were pooled together and then converted to Mortgage Backed Securities. MBSs were converted to Collateralized Debt Obligations. CDOs were converted to CDO squareds. If you only planned to hold a mortgage security for a brief period and then pass it along, like most of the securities' creators, you cared little about the quality.

This process was aided and abetted by the ratings agency. The ratings agency also had a powerful incentive problem: they were compensated based on volume. This encouraged them to rate as many structured products as possible, even when they didn't understand them. Worse, the ratings agency used the same scale for structured products as they did for corporate borrowing. Experts like Professor Joseph Mason of Drexel University have demonstrated that a structured product with a BBB rating was far riskier than a corporate bond with an identical BBB rating.[12] Mason pointed out that the returns themselves were pointing to the mis-ratings, noting in early 2007 that some AAA structured products were returning yields of 200 basis points to their investors while returns on AAA corporate bonds were returning 10 to 20 basis points.

Even worse, the very act of rating a product encouraged the private sector to stop performing due diligence. Professor Mason notes that investors were given "full access to in-house team of quants and market risk specialists, thereby enabling them to out-source the entire CDO risk management process to third party experts." While some investors with fine intentions may have outsourced their risk management in good faith, other investors undoubtedly shopped for yield and a grade while caring little about understanding the enormous complexity behind the products. After all, Warren Buffet himself pointed out that one would have to read 750,000 pages of documents to understand a single CDO.[13] Most pension funds and insurance companies, by regulation, can only buy investment grade products, and usually high grade ones. This can entice managers to shop for the products with the highest yield for a given grade, rather than to actively question why the product might have a higher yield despite having a similar grade. Based on UBS and Intex data from February 2008, 91 percent of outstanding Alt-A MBS securities were rated triple A and 65 percent of outstanding subprime MBS were rated triple A.[14] And MBS tranches that didn't make the investment grade cut could be converted into investment grade through the CDO machine. The IMF May 2007 Financial Stability Report found, that by using CDOs to rearrange risk within an MBS tranche and adding credit enhancements, 85 percent of a hard to sell triple BBB MBS tranche in a mortgage pool could be converted into triple A securities.[15] Grade inflation was rampant. It is also true that investors, domestic and foreign, were behaving like cattle.

But for banks to be able to load up on structured products, in addition to simply creating and selling them, they needed to expand their balance sheet. From 1975 to 2004, the SEC had a strict net capital rule on broker-dealers that effectively capped their leverage. Under the rule,

---

[12] "Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions," Mason, Joseph, and Rosner, Joshua, Hudson Institute, February 3, 2007.

[13] "What Warren Buffett Thinks," Fortune Magazine, April 14 2008.

[14] Zimmerman, Thomas, Managing Director U.S. Securitized Products Strategy Group, UBS, "Deflating the Mortgage and Housing Bubble, Part IV," October 30, 2008.

[15] "When is a AAA not a AAA?", IMF Financial Stability Report, April 2008.

broker-dealers had to compute net capital daily, valuing all liquid assets at market prices and then applying a fixed haircut by asset type. Under the rule, the broker-dealer was limited in the amount of debt it could incur to about 12 times its net capital.[16] After years of being lobbied, the SEC relaxed this requirement in 2004, allowing banks to instead make their own net capital calculations using mathematical models to price positions and Value-at-Risk models. Strict limits on debt were also dropped. As a result, investment banks like Bear Stearns and Lehman Brothers quickly expanded their leverage, with simple leverage ratios exceeding 30 to 1. The banks argued that much of their book was matched assets and that their VaR based risk systems ensured more-than-adequate capital, assuming that historical correlations held true. But reality is the ultimate proof, and the models failed. Asset correlation and market volatility rose sharply. Leverage is risk.

Guidance for Policymakers

Central bankers around the world must more actively incorporate asset prices into their policy decisions. When asset prices are rising rapidly, policy should be tightened more than otherwise would be the case. There is no rule for how much policy should be tightened, precisely because rule-based monetary policy does not work. Economies are dynamic. Each boom is different. Each recession is new. While no policy or model can guarantee against another boom bust cycle, a keen observer with generations of experience will recognize an asset bubble when he or she sees one. And when one is spotted, the answer is not a shrug of a shoulder. The central bank must engage in a debate with the market, and be willing to back up their opinion with a curtailment of the credit growth that is fueling the bubble. It is better to put the brakes on early on then to let a bubble find its natural peak. History says that this can be quite high indeed.

The Federal Reserve needs to take a more active role in promoting financial stability. While the Fed has from creation adopted the lender of last resort role, providing liquidity during financial crises, it has not always embraced a policy of mitigating boom bust cycles. A full reading of the Monetary Policy Objectives under the Federal Reserve Act reveals that they must do more:

> "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of monetary and credit aggregates commensurate with the economy's long run potential to increase

[16] Pickard, Lee A., former director of SEC Division of Trading and Markets, "Viewpoint: SEC's Old Capital Approach Was Tried – and True," American Banker, August 8, 2008.

production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."[17]

The Federal Reserve likes to describe its mandate as a dual mandate to fight both unemployment and inflation. But a proper reading of its mandate reveals at least five obligations. Most interestingly, the current mandate of the Federal Reserve directs it to control credit aggregates. This means the Federal Reserve has not only the authority to pro-actively prevent an excessive credit expansion; it is obligated to under the law, an obligation it has chosen to ignore for over a decade. This gives the Federal Reserve a responsibility to prevent asset bubbles since they are fueled by excess credit. This objective could be achieved with interest rates, prudent regulation or by using the bully pulpit. Regardless, the Chairmen of the Federal Reserve and other voting members must believe that bubble prevention is a proper role for the central bank. If they want to react to asset markets on their way down, they need to react on the way up as well.

Policymakers must also rethink housing policy to reduce leverage. The first policy should be raising the down payment standard of all government housing assistance programs. The FHA loan policy should be phased up to 10 percent from the current 3½ percent. Refinancings of old loans can be exempted to prevent struggling homeowners from getting out of punitive loans made in the past. Note that even a 10 percent down payment would be twice as lenient as the reasonable standard two decades ago of 20 percent down.

The mortgage interest deduction should also be phased out over time, or reduced as much as is politically feasible. (An immediate repeal would put more downward pressure on home prices and place an added burden on homeowners during already tough economic times.) The mortgage interest deduction costs the federal government $95 billion a year, providing substantial resources for better designed programs.

One way to proceed would be for the Federal government to provide a down payment match for first time homeowners in lieu of existing subsidies on leverage, an idea that has been advocated by Columbia Professor Charles Calomiris. Any down payment program must be carefully designed to not completely substitute for the homeowner's ability to save. It would be fairly simple to design a program that lowered down payment costs for first time homeowners substantially, at a fraction of the cost of the home mortgage interest deduction, while creating a substantial equity stake in their home.

The third focus of policymakers should be debt in the financial sector. A large part of the financial system, most notably commercial banks under the regulation of the FDIC, already has an effective limit on their leverage. These banks are subject to a simple leverage ratio that caps

[17] www.federalreserve.gov

their assets relative to their capital. For these banks, if the leverage ratio (here calculated as capital divided by assets) drops below 4 percent, the FDIC must start supervisory intervention. And if the leverage ratio drops below 2 percent, the bank is considered critically undercapitalized and is shut down. This system means that any bank that is leveraged more than 25 to 1 will be under intense regulatory scrutiny. Banks hate these simple calculations because they cannot easily be skirted, which is the very point. The leverage ratio should be the base for controlling leverage for the entire U.S. banking sector and for large global banks as well.

Banks are inherently risky entities. John Maynard Keynes once quipped that a prudent bank is one that goes bust at the same time as all other banks. But this inherent riskiness is why banks need more limits than other parts of the economy. Georgetown Law Professor Dan Tarullo points out that a leverage ratio, because of its simplicity, transparency, and bluntness, could provide a useful "common language" for bank regulators around the world.[18] He argues that, because of its bluntness, a leverage ratio should be used more as a safety net, with more sophisticated forms of regulation enhancing bank surveillance. Former FDIC Chairman Don Powell also favors using the simple leverage ratio as a basis for international regulation. This approach is also looked favorably on by Canada and Switzerland.

Once again, much of the policy consensus has been wrong. The past decade has been dedicated to negotiating the Basel II bank regulations. Basel II, however, favors complexity over simplicity. Bank capital is determined by banks own models, precisely what allowed them to adopt so much leverage in the first place. In trader talk, Basel II allowed all sorts of assets to be leveraged to the maximum. Basel II standards should be supplemented wherever they apply with a simple leverage ratio that provides a firm regulatory backup to prevent new regulatory schemes from being gamed. A simple backstop should not take another decade to negotiate.

Of course, a leverage ratio only works if banks are forced to keep assets on balance sheet, not hidden in complicated off balance sheet entities. The implementation of FAS 140 in 2010 should make banks move most of their off-balance sheet activity back on the balance sheet. The IMF estimates that even a milder form of FAS 140 would move $2 trillion of assets back onto U.S. bank balance sheets during the 2010 to 2012 period.[19]

Conclusion

In Washington, the world is often seen through the federal budget, and the definition of prudence is too often defined narrowly by the size of the budget deficit or surplus. But this is far

[18] Tarullo, Dan. "Banking on Basel." Institute for International Economics, August 2008.
[19] IMF, Financial Stability Report, October 2008.

too narrow of a definition, with federal liabilities accounting for only 10 percent of the domestic credit markets. Policymakers must broaden their focus to addressing debt throughout the economy, and measure this debt relative to things that matter: sometimes narrowly like bank capital or down payments, and sometimes widely like production and income in the economy. In other words, policymakers must keep their eye on leverage everywhere, not just in Washington.

Central bankers have a special role in avoiding the boom bust cycle we have endured over the last ten years by restricting excessive credit creation when necessary. The achievement of price stability, narrowly defined, was once regarded as the ultimate success, while their silence on asset bubbles was seen as an endorsement of higher prices. The results of this "benign neglect" view of asset bubbles have been too devastating as the U.S. economy is likely in the deepest downturn since the Great Depression.

This boom bust cycle was exacerbated by the psychology of a bull market, which adversely affected the judgment of home buyers, market participants, and regulators. Most of these mistakes were not done with bad intentions. But now the whole notion of ownership, responsibility, and prudent risk has been undermined. If anything, blame could be cast much wider than has been described here, touching all aspects of society. But much more important than distributing blame is moving forward with simple, prudent and effective policy solutions.

Professor WARREN. Thank you, Mr. Sumerlin. And Mr. Wallison.

STATEMENT OF MR. PETER J. WALLISON, ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

Mr. WALLISON. Thank you.

I'm very pleased to have this opportunity to testify today and I assume my prepared remarks will be——

Professor WARREN. Of course.

Mr. WALLISON [continuing]. Put in the record. My testimony actually will focus mostly on safety and soundness regulation, but I'd be happy to answer questions about any other kind of regulation.

With the limited and disastrous exception of the major investment banks, the Federal Government has never regulated the safety and soundness of financial institutions for which it does not assume some financial responsibility. There are sound and strong reasons for this.

First, regulation itself introduces moral hazard. Participants in the financial markets may believe that government supervision reduces the likelihood of missteps or failure and this impairs market discipline.

Second, regulation also impairs competition, suppresses innovation, increases consumer costs, and enhances the likelihood that taxpayers will be called upon to bail out regulated companies.

Third, there is no policy reason why the government should take responsibility for preventing the failure of financial institutions that it does not back. In general, business failures are good for the economy and the financial system. They remove bad management and bad business models and make room for good management and business models. If regulation is in fact effective in preventing bad management from failing—which is doubtful in any case—it would be preserving bad management and business models.

Fourth, regulation is apparently not effective in preventing business failures. We can see that from the current financial crisis in which heavily-regulated commercial banks are in the most trouble. In fact, given the disastrous conditions of the banks, it is difficult to understand why anyone would be calling for the regulation of other participants in the financial system.

If regulation does not prevent failures, why impose its costs on consumers and taxpayers?

Nevertheless, only a recently-landed Martian would not realize that there is a major move afoot in Congress to broaden the scope of regulation to include other participants in the financial markets.

The ostensible reasons for this are usually two. Regulation, it is said, will improve transparency and reduce systemic risk. As outlined in my prepared testimony, neither reason is persuasive. Transparency itself is a reasonable goal, but it is not worth the tangible and intangible costs of regulation when institutions are dealing solely with sophisticated counterparties. These counterparties can fend for themselves and know what questions to ask.

As to reducing systemic risk, there are no examples of the failure of a non-regulated institution causing systemic risk, including LTCM, Lehman and AIG or any of the hedge funds that have closed their doors this year.

Lehman's failure did not cause systemic risk. No institution failed or was threatened with failure because Lehman collapsed. The market freeze-up after Lehman was not caused by losses coming from Lehman's failure but by a sudden recognition on the part of banks and others around the world that their counterparties might be very weak and unstable and that the U.S. Government could not be expected to rescue them.

Accordingly, the proponents of new regulation, based on the danger of systemic risk, should explain why it is suddenly necessary.

Finally, it would be a very bad idea to empower some agency, the Federal Reserve or anyone else, to identify systemically-significant institutions and regulate them as such. This would have very adverse effects on competition. By creating the impression that some institutions are too big to fail—which is what it means to be designated as systemically significant—such a policy would create an unlimited number of Fannies and Freddies that would have huge competitive advantages over others in the same industry.

As we can see from bank regulation, traditional financial supervision does not work anyway and will not prevent financial failure. To be sure, there are some areas where regulation is necessary, especially when financial institutions, like commercial banks, are backed by the Federal Government. The GSEs are another example.

Accordingly, in my prepared testimony, I recommend a few major changes in traditional regulation for these cases of necessary regulation. The purpose of these reforms is to enhance market discipline and make regulation counter-cyclical rather than pro-cyclical as it is today.

To assist creditors and counterparties, I suggest that regulators should work with analysts and the regulated industry to create metrics or indicators of risk-taking. These would be published regularly and help potential creditors understand the risks that regulated institutions are assuming.

Professor WARREN. One more paragraph.

Mr. WALLISON. This would make market discipline much more effective. I also recommend various steps that will make regulation counter-cyclical, including changes to fair value accounting, requirements for regulators to consult market sources for risk assessments, requirements for capital increases when asset values are rising, and the enhancement of the role of short sellers and hedge funds.

Thank you very much.

[The prepared statement of Mr. Wallison follows:]

Testimony of

Peter J. Wallison

Arthur F. Burns Fellow in Financial Policy Studies

American Enterprise Institute

Before the

Congressional Oversight Panel

January 14, 2009

Madame chair and members of the Congressional Oversight Panel:

I am pleased to have this opportunity to offer my views on the important questions on regulatory reform that Congress has asked you to consider. We are in the midst of a serious financial crisis, and there is a temptation to act precipitously, without thinking of the long-term consequences. It is cliché at this point that Congress does not act except in a crisis, and then it acts without thinking. Years later, lawmakers scratch their heads at the unintended consequences they themselves have caused. It is encouraging that Congress has asked for your views on what new regulatory responses, if any, are necessary. I hope this panel will take adequate time to consider the issues discussed in this testimony, as well as others that are likely to come before Congress in the near future.

My testimony begins with a discussion of the deficiencies of regulation—its tangible and intangible costs—and then proceeds to a discussion of where safety and soundness regulation is necessary. Thereafter, for those areas where regulation is necessary—that is, in cases where the government is backing private companies—I outline what broad changes I believe should be made in regulatory policies. After that, I critique some of the ideas that have been advanced recently for a broadening of safety and soundness regulation beyond those financial institutions that are backed explicitly or implicitly by the government. Finally, I outline what I think should be the boundaries of business conduct or consumer protection regulation.

Regulation should be counter-cyclical and support market discipline

The overwhelming fact about traditional safety and soundness regulation—in which a government agency oversees the operations of individual companies—is that it has been a consistent failure. The S&L debacle, less than 20 years ago—when the S&L industry as well as almost 1600 commercial banks failed—was followed by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which significantly tightened bank and S&L regulation. Now we have a mammoth financial crisis in which all depository institutions, both S&Ls and commercial banks, are the principal sources of financial weakness. Many have already failed; others will fail; and dozens have been saved from failure by the infusion of taxpayer funds. In other words, we have strong evidence that the current regulatory system has been not been effective in preventing financial breakdowns. What has been tried in the past does not work. It's time to try a new approach.

In addition to its demonstrated failure in preventing financial collapse, there are other deficiencies of regulation that get very little attention because they are difficult to quantify or their failures are not as obvious. Here are a few of the issues that economists and others have always cited for their skepticism about regulation:

- The existence of regulation—especially safety and soundness regulation—creates moral hazard. Market participants believe that the government is looking over the shoulders of the regulated industry, and lenders are thus less wary that regulated entities are assuming unusual or excessive risks.

- Regulation reduces competition. The costs of regulation are more easily borne by large companies than by small ones. Large companies have the ability to influence regulators to adopt regulations that favor their operations over those of smaller competitors. This is particularly true when regulations add costs that smaller companies cannot bear. Regulation also may keep low cost producers or foreign competitors out of regulated markets.

- Regulation impairs innovation. Regulatory approvals necessary for new products or services delay implementation, give competitors an opportunity to imitate, and add costs to the process of developing new ways of doing business or new services.

- Regulation adds costs to consumer products. Regulatory costs are passed along to consumers in the cost of services or products. These costs are frequently not worth the additional amount that consumers are required to pay.

These deficiencies—together with its regular failure as a protection for the taxpayers or the economy—suggest that regulation should be a last resort, employed only when absolutely required. In this connection, there are several circumstances that may meet this standard:.

- When a company or an industry has the backing—implicit or explicit—of the government. Explicit backing exists, for example, with commercial banks. Implicit backing occurred when Fannie Mae and Freddie Mac were allowed to continue operating with government charters and other benefits that told the market these companies would never be allowed to fail. In these cases, the wariness of creditors is impaired and market discipline is reduced, allowing more risk-taking than would normally occur. Because of its adverse effect on competition, and its tendency to create taxpayer liabilities, government backing—explicit or implicit—should be avoided.

- When the failure of a particular company or financial institution will have systemic effects. There are elements of the self-fulfilling prophesy here. If we designate companies as "systemically significant" we will certainly allow them to become so, because the designation itself reduces or eliminates market discipline and allows them to grow faster than their competitors. In normal markets, it is very difficult for companies without government backing to become systemically significant, and currently the only companies that can be so considered are already regulated as banks.

- When there is a significant asymmetry of knowledge between a supplier of services and its customers. Personal insurance lines such as homeowners, auto, or life, are examples of this. The complex contracts required for this service are beyond ability of most consumers to understand. States or federal regulation is necessary in this case for consumer protection. The same may be true of mortgage loans. It may well be that some homebuyers do not understand the commitments they are making when they sign up for mortgages with low teaser rates and high resets. In these cases, regulation may be required to assure that the risks are made known to them in clear and simple language.

- When there is a regulatory failure of another kind, such as a harmful pharmaceutical product that could be marketed before the dangers could be known by those who use it..

Assuming, then, that regulation of safety and soundness (in other words, risk-taking) is appropriate for one of these reasons, we should be looking for ways of carrying it out that are more effective than the failed systems of the past. In searching for these new ways, we should keep two things in mind—both of which are founded on what we know about human nature. First, incentives matter. The people who are likely to be most effective in combating risky behavior in regulated companies are those who are most likely to be injured by it. In the case of safety and soundness regulation, those most likely to be injured by risk-taking are creditors. In general, creditors—unlike equity investors—get no benefit from risk-taking behavior, so they have an incentive to control and limit it. When they have the necessary information and are able to use it in a timely manner, creditors limit risk-taking by withholding funds or seeking higher interest rates on loans in order to compensate them for additional risk. This is known as market discipline. Good policy, then, would focus regulation on helping creditors exercise market discipline.

Another element of human nature with which we are familiar is the tendency to believe that when prices are going up they will continue to go up, and when they are going down that trend will also continue. In other words, as many have noted, we are subject to both irrational exuberance (manias) and panics. The current financial crisis is the result of both—a huge real estate bubble that drove housing prices well beyond the ability of people to reasonably afford, and then a collapse in prices—driven by panic—which is still continuing. The Fed is now desperately trying to avoid a deflationary spiral because of the tendency of people and businesses to sell all at once when they believe asset values are going down. So the second thing we ought to be looking for in regulation is counter-cyclicality—the incentive and the ability to act against, or encourage others to act against, the development of either bubbles or panics. This is very difficult in a political environment, because Congress does not want to stop the party when everyone is having fun (the constituents are happy), and adds to the panic by blaming everyone in sight (except itself and its policies) when things look bleak.

With these thoughts in mind, there are some things that can be done to improve regulation, where regulation is actually needed.

- **Fostering market discipline through published metrics**. Market discipline can be enhanced through greater transparency and more information for market participants. To some extent, this is already being accomplished through credit default swaps, which create a market-based assessment of credit quality that is accessible to all lenders. But regulation and regulators can help by working with analysts and regulated industries to develop metrics or indicators of risk-taking and then making sure that these are published regularly and accurately.

- **Reducing government's distortion of markets**. The government's participation in markets distorts outcomes and should to the extent possible be eliminated. The government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac were largely responsible for the vast inflation of the housing bubble, and particularly the subprime and other weak mortgages that are now responsible for most of the mortgage defaults that are driving down housing prices and causing economic recession. The ability of Fannie and Freddie to use their government backing to raise large amounts of low-cost funds was highly pro-cyclical. As housing prices increased, Fannie and Freddie looked healthier and more prosperous, making it easier for them to raise more funds to push housing prices up further. If they had not had access to the government's credit card, they would have had to compete for funds with other economic priorities, but the perceived safety of lending to Fannie and Freddie put them at the head of the line for new funds.

- It is more difficult to make regulation counter-cyclical, but a few ideas should be considered:
    - **Mark-to-market accounting**. Fair value accounting should be revised and reformed. As things stand today, we have an accounting system that is pro-cyclical rather than counter-cyclical. When assets increase in market value, they can be written up—in some cases adding to the bottom lines of financial institutions—but when the market turns sour or panics, assets are excessively written down, causing financial institutions to appear weaker than they are. A sensible accounting system—one that takes account of the realities of human nature and behavior—would deny companies the opportunity to write up assets when the market is in one of its euphoric stages (say, when prices have increased by a certain percentage over the last 12 months), and similarly not require writedowns when prices have fallen precipitously during a rapid downturn as in the collapse of a bubble. In these cases, alternative asset valuation procedures—such as discounted cash flow—should be used, and it should be made easier for financial institutions to declare assets as held-to-maturity during these periods. In normal markets, prices will fluctuate within a limited range, and will rise slowly if at all.
    - **Regulators use of market indicators**. Prompt corrective action (PCA), which was first introduced into banking law with FDICIA, has been modestly effective in preventing the natural regulatory tendency to forbear on closing weak or failing institutions. The trouble with it is that it depends on regulators making judgments about capital positions that they themselves control. It is too easy for regulators to accept the arguments of regulated entities that their capital positions are stronger than they appear. Prompt corrective action should be strengthened by requiring regulators to take account of spreads in the credit default swap markets. Another mechanism would be requiring larger institutions to issue a special kind of subordinated debt that could not by law be bailed out. The interest rate on that debt would also be an indicator of the market's perception of the risk-taking by the financial institutions that have such debt issued and outstanding.
    - **Counter-cyclical capital requirements.** Regulators are subject to political interference that prevents them from acting counter-cyclically. This is a particular problem when markets are rising, regulated entities look healthy

and consumers and investors are happy. The regulators who spoil the party will be very unpopular, and—as chairman Barney Frank has noted (in a different context)—you get no credit for harms avoided. There is no way to keep Congress or the administration from interfering in the regulatory process by punishing regulators for acting counter-cyclically, but regulators can be required to demand increases in capital during flush times, so that regulated companies are putting away reserves for leaner periods. This would be an effective counter-cyclical measure that would be responsive to the problem of pro-cyclicality in regulation.

- **Counter-cyclical selling and hedging.** There are groups in the economy that profit from betting against trends. These include short-sellers and hedge funds—to name two business models that are less likely than others to be carried away by the euphoria that occasionally afflicts market participants. Short-sellers are particularly despised when markets are falling, but no one pays much attention to them when markets are generally rising. In those conditions, they tend to moderate the rise of bubbles. It is particularly ill-advised to require an artificial restraint on short-selling such as the uptick rule. That has the effect of enhancing the likelihood of bubbles by limiting the moderating effect of short-selling. The regulation of hedge funds could have the serious adverse effect of limiting their activities in hedging against market downturns. This hedging activity can look like speculating in favor of losses for other investors and can induce regulators under political pressure to take steps to prevent it. The recent SEC activity in banning short-selling in the shares of financial institutions is an example of a regulator reacting to these pressures. To keep this from happening in the future, shortselling should be defined in the law and specifically protected. Of course, spreading false rumors in order to drive down a stock's price should be punished.

These measures form a kind of conceptual hierarchy. First, we should recognize the deficiencies and failures of regulation. Then we should consider that, despite these deficiencies and failures, regulation is necessary when companies or financial institutions enjoy government backing. When some regulation is required, its focus should be on two objectives: (i) enhancing market discipline by requiring regulated entities to publish metrics and indicators of risk-taking that will alert creditors to excessive risk-taking, and (ii) structuring regulation so that it is counter-cyclical in its operation.

Using this hierarchy, it is difficult to see that extending regulation beyond GSEs, commercial banks and S&Ls would be productive or useful. It would impair competition and innovation, raise consumer costs and interfere with the market discipline that is one way to hold risk-taking in check. An exception might be made for the companies at the entry point to the mortgage finance system—mortgage brokers and other local originators. It may well be that their customers don't fully understand the risks they are assuming when they accept complex mortgage products. The choice here would be to restrict or eliminate the use of these products, or assure that those who sell them are licensed and that the risks are adequately disclosed. If we are realistic about human nature, it seems likely that no amount of disclosure will prevent a person from signing up for a mortgage with a teaser rate and a steep reset if he believes that housing prices will rise sufficiently so that he will be able to sell the home if he can't afford the reset rate. So if we want to have effective regulation in this case, teaser rates should simply be prohibited. The same approach might be taken with high loan to value lending, negative amortization, or interest only loans. All these innovations will be abused if homebuyers believe that prices are going up.

If we want to go this far in regulating the mortgage business, there are a few other policies that would help to prevent the recurrence of a housing meltdown in the future like the one we are experiencing today. First, the prevalence of non-recourse mortgages throughout the United States has encouraged the phenomenon of people walking away from their mortgage obligations when the mortgage on their homes is higher than the homes' value. If people understood when they signed up for a mortgage that they are personally liable on the note they might be less inclined to take on mortgages that they may not be able to afford. In no other area of this or any other economy are people offered a free option to abandon their obligations when they turn out to be on the losing side of an investment.

Second, we allow mortgages to be refinanced without penalty at any time, so that when the value of the home has risen homeowners are able to refinance and take some of that price appreciation out in cash. Prepayment of an obligation without penalty is very rare in commercial transactions. Because it requires the lender to hedge the risk of prepayment, it raises the costs of borrowing for everyone Cash-out refinancing tends to reduce the equity that remains in homes when prices decline—as they inevitably do—and that exacerbates the tendency of people to walk away from their mortgage obligations when the loan is non-recourse.

Third, tax laws permit the interest on home equity loans to be tax deductible, which in turn encourages homeowners to borrow against the equity in their homes to pay off credit card or other debt, the interest on which is not tax-deductible. This too reduces the equity in the home when the downturn comes.

If we want to be sure that there is equity in homes when the next bubble bursts, we should preempt state laws that permit nonrecourse mortgages and refinancing of mortgages without penalty, as well as those provision of federal tax laws that encourage homeowners to borrow against the value of their homes.

Critique of calls for broader safety and soundness regulation

Since the advent of the financial crisis, many observers have argued that the current crisis is the result of excessive trust in the ability of markets to regulate themselves. Occasionally, these critiques go as far as to claim that this has been the prevailing theory of the last 30 years and has been proved wrong by the financial crisis. The fact that some unregulated or largely unregulated institutions have failed during the financial crisis is cited as evidence that there is a need for greater government oversight of the financial system.

This formulation misstates the history of financial regulation, ignores the fact that the most regulated parts of the economy are the cause of the most financial trouble, and fails to explain why it would be necessary for the federal government and the taxpayers to prevent the failure of any company or industry that is currently not regulated

Taking these points in turn, there has been no "theory" during the last three decades that private markets and private financial institutions could largely be trusted to regulate themselves. The theory that has prevailed over the last three decades is the same theory that has governed U.S. government policy on financial regulation for the last 200 years—that there is no sound policy reason for the federal government to regulate or protect the safety and soundness of any financial institutions that are not backed in some way by the government. The idea that the federal government has in some sense withdrawn its regulation of financial institutions over the last 30 years—or that a different theory about financial regulation prevailed in the past—is entirely fallacious.

With the limited exception of the five largest investment banks (discussed below), federally-backed commercial banks, savings and loans (S&Ls), and the government sponsored enterprises (GSEs) Fannie Mae and Freddie Mac are the only financial institutions that have ever been regulated for safety and soundness at the federal level. In 2004, in response to a demand by the European Union that securities firms operating in the EU have a consolidated home country safety and soundness regulator, the SEC assumed the role of safety and soundness regulator for the five largest investment banks then doing business in the EU. This proved disastrous, as all five took advantage of the appearance of government regulation to overleverage themselves. But with this one exception to the general rule, it is necessary to recognize that there has never been a theory that the federal government has—or should have—any responsibility for regulating the safety and soundness of financial institutions it does not back. The policy reasons for this consistent federal position—as outlined below—are overwhelming.

In addition, to suggest, as many have, that the current financial problems of unregulated entities are in any sense or degree different from the current financial problems of regulated entities is obviously wrong. Assuming that we treat the investment banks as unregulated, there has been only one total failure among these institutions—Lehman Bros.—while four others have either been rescued (Bear Stearns) or sought shelter against the consequences of a profound loss of market confidence in their stability or solvency. It may well be that all these institutions would have ultimately failed, but this result must be compared with the failures of the many heavily regulated banks and S&Ls that have failed thus far, and particularly the multi-billion dollar rescue of at least one bank—Citibank—that was overseen continuously for years by the Comptroller of the Currency. The argument that the failure of unregulated financial institutions was the result of their lack of regulation is clearly unsustainable; it completely ignoring the fact that many more fully regulated entities have suffered the same fate. If regulation does not produce a better result than non-regulation, there is no reason to pursue it.

Finally, the reason that the federal government has not regulated currently unregulated financial institutions is that there has never been a sound policy reason for the government to prevent the failure of financial institutions that it is not backing, and many sound reasons for the government to stay its hand. At the outset of this testimony, I suggested four reasons for regulation in general. This includes what would be called business conduct or consumer protection regulation as well as safety and soundness regulation. In this testimony, I am discussing only safety and soundness regulation—i.e., regulation that is intended to keep financial institutions from failing, rather than regulation that attempts to assure that customers and clients are treated fairly.

What could be the reason that the government might want to regulate the safety and soundness, or—more specifically—the leverage, of financial institutions for which it has no financial responsibility? It is of course generally understood that the failure of companies is a good thing. Bad managements or bad business models are eliminated from the economy, making room for good managements and better business models. The losses of investors and creditors make them cautious about their investments and loans in the future, so that market discipline is enhanced. Why would the government want to prevent these salutary results from occurring? In addition, why would the government want to impair market discipline by creating moral hazard, reduce innovation and competition, and increase consumer costs—all well-known consequences of regulation? Among reasons for regulation cited at the beginning of this testimony, the only one that seems plausible as a basis for safety and soundness regulation is its interest in preventing defaults that might have system-wide consequences—i.e., the possibility that the failure of one institution causes other failures throughout the economy through a process of contagion. This is known generally as systemic risk.

It is important to emphasize at this point that this has never happened. There is no example in all of U.S. history where the failure of a non-regulated financial entity—securities firm, hedge fund, insurance company (if insurers are considered non-regulated because they are regulated only at the state level), finance company or private equity fund—caused a systemic breakdown. In 1990, for example, when Drexel Burnham failed, there was no systemic result. Occasionally, the example of the hedge fund LTCM is cited. What we know of that event is that the Fed—fearful that a systemic event would ensue if LTCM failed—brought together a number of large lenders to LTCM and suggested that they rescue the fund, which they did. We don't know what would have happened if they had not, and many scholars believe that the Fed overreacted. In any event, LTCM never failed and there was no systemic event. In order to maintain that there is now a policy basis for regulating firms and industries that have not previously been regulated, there must be a showing that there has been a change in the historical pattern—that now market conditions are different. I am not aware of any such showing.

In reality, there is no evidentiary basis whatever for arguing that the financial market is any different today than it has always been, or that the failure of an unregulated entity today would have a systemic effect on the economy as a whole, even though there are no hisotircal precedents. Reports in the media that the financial markets are now more "interconnected" are not evidence of any change. Financial markets have always been interconnected. That's why financial institutions are called "intermediaries." It is through financial intermediaries that money moves from where it is less useful to where it is most useful. There is nothing about the financial markets today that makes them more interconnected than they have ever been. It is true that money moves faster, and this makes it possible for investors and counterparties to move their funds more quickly from institutions which they regard as troubled, but this is not an indication that the markets are more interconnected, so that the failure of one institution will bring about the failure of others.

This is demonstrated by the failure of Lehman Bros. At the time Lehman failed, there was a strong adverse reaction in the financial markets. Banks stopped lending to one another, and the credit markets in general froze. We are still living with the results of that event. However, Lehman's inability to meet its obligations did not result in the "contagion" that is the hallmark of systemic risk. As discussed below, nb banks or any other Lehman counterparty seems to have been injured in any major respect by Lehman's failure, although of course losses occurred. The markets freeze-up was caused not by these relatively minor losses but by fears on the part of banks and other financial institutions that the Lehman failure signaled unexpected weakness in other institutions and forced a sudden recognition that governments would not prevent runs by their own depositors and counterparties. These banks knew they would have to close if they could not meet depositor or investor demands for cash. Although there were media reports that AIG had to be rescued shortly after Lehman because it had been exposed excessively to Lehman through credit default swaps (CDSs), this turned out to be another canard. When all of the CDSs on Lehman were settled about a month later, AIG's exposure turned out to be $6.2 million—a rounding error for this huge company. Moreover, although Lehman was one of the largest players in the CDS market, all its CDS obligations were settled without incident, and all the CDSs written on Lehman itself were settled for a cash exchange among hundreds of counterparties if $5.2 billion. There is no indication that any financial institution became troubled or failed because of the failure of Lehman.[1]

The question then becomes whether it is an adequate reason to regulate currently unregulated financial institutions because, in the future, investors and financial intermediaries like banks might again panic as a result of the failure of a large institution like Lehman. The pros and cons are easy to outline. I have already mentioned that there are good policy reasons to allow companies to fail, or at least to stop the government from preventing their failure. The reasons most often given for regulating currently unregulated entities are usually two: regulation will induce more "transparency," and the government rescue efforts in the current crisis have created moral hazard by suggesting to investors that many institutions are too big to fail. Sometimes this last idea gives rise to suggestions that a government agency should be empowered to identify "systemically significant" financial institutions and regulate them accordingly.

Turning first to the issue of transparency, I noted at the outset of this testimony that transparency is important in fostering market discipline, and suggested that the goal of regulation—where regulation is required because of government backing—should be to develop metrics or indicators of risk-taking and make sure that regulated entities publish these indicators accurately and on a regular schedule. Is the same requirement necessary for unregulated entities? The answer is no. Unless there is a policy reason for the government to regulate any entity, it should not do so. Government regulation that requires transparency already exists in the only area where it is necessary—disclosure required by the securities laws for companies and others that sell seek investments from the general public. Government regulation is not necessary to protect sophisticated individuals and institutions, which should know the questions to ask before they advance credit or invest in equity. If these institutions do not know the questions to ask, they should be eliminated from the market by failure, just as badly managed companies should

---

[1] As an aside, CDSs are no different from loans. If, as AIG did, a company writes protection on a loan, what it has done is not essentially different making the loan itself. The widely bruited concerns about CDSs are unfounded. There is no evidence that they create any more risks than lending itself. See, Peter J. Wallison, "What You Always Wanted to Know about Credit Default Swaps –But were Never Told," *Financial Services Outlook*, AEI, December 2008, available at http://www.aei.org/publications/filter.all,pubID.29158/pub_detail.asp.

be allowed to fail. Again, unless there is some policy reason for the government to prevent the failure of investors or creditors, there is no reason for the taxpayers to assume this obligation.

The final question, then, is whether the government rescue efforts during the current crisis have created so much moral hazard that the regulation of otherwise unregulated institutions is now necessary. This is a bit of bootstrapping by those who favor regulation. No hedge funds, for example, have needed a rescue by the government. And although many have closed their doors, and none of these closures has created a systemic event. So whatever the government has done to rescue AIG or GMAC is not an argument for regulating hedge funds because the government has created moral hazard. It is an argument, perhaps, for regulating finance companies like GMAC, but that doesn't seem like a particularly urgent need. At its base, the argument relies on a twisted bit of logic: regulated and nonregulated companies have been rescued; therefore nonregulated companies should be regulated.

The suggestion that a government agency should be empowered to designate systemically significant institutions and regulate them more fully than others is a particularly pernicious idea. It is especially troubling because it seems to ignore the obvious consequences of such a policy. Even assuming that it is possible to identify systemically significant institutions in advance of their failure, what would such a designation mean? Clearly, that the institutions involved would not be allowed to fail—that is the reason they are being designated as systemically significant. If these institutions are not going to be allowed to fail, they will have substantial competitive advantages over institutions that are not so designated. They will have easier access to capital and loans and they will grow faster. Other, presumably smaller, competitors, seeking the same advantages will consolidate in order to be considered within the category of the elect few that will not be allowed to fail. In other words, designating institutions as systemically significant will have essentially the same result as creating a new crop of government sponsored enterprises like Fannie Mae and Freddie Mac—only this group will be an open-ended category that virtually any company could join if it could prove to the designator that it is a threat to the system because of its size. The effect of this idea on our competitive system would be dire.

What's more, the designation of certain companies or financial institutions as systemically significant, opening the possibility that government will keep them from failing—far from making the financial system more stable—will have the effect of increasing the number of failures. In his famous book, *Manias, Panics and Crashes,* Charles Kindleberger recognizes this problem:

> When asset prices tumble sharply, the surge in the demand for liquidity may drive many individuals and firm into bankruptcy, and the sale of assets in these distressed circumstances may induce further declines in asset prices. At such times a lender of last resort can provide financial stability or attenuate financial instability. The dilemma is that if investors knew in advance that government support would be forthcoming under generous dispensation when asset prices fall sharply, markets might break down somewhat more frequently because investors will be less cautious in their purchases of assets and of securities. (5^{th} edition, p 14)

It is not possible to cure moral hazard by injecting more of it into the economy. The fact is that systemic risk is context-specific. As noted above, when Drexel Burnham failed in 1990, the markets were stable and functioning normally. There was very little reaction and no systemic problems that arose because of this failure. However, in 2008, when there was doubt about the solvency and stability of most of the world's major financial institutions, the failure of Lehman Bros. produced a significant effect, even though there is no evidence that Lehman's failure to meet its obligations resulted in any substantial adverse effects for any other financial institution. For this reason, it is impossible to know in advance whether the failure of a particular institution will have a systemic effect and when it will not. The effect of a failure will depend on the nature of its relationships with other institutions, and the financial condition of those others at some future time.

The Lehman example seems to demonstrate that even when a major institution fails at a time of profound market panic the actual systemic risks are minimal. Other institutions come to fear runs by their depositors and counterparties, but they don't suffer life-threatening losses as the result of the failure. Nor is it possible to argue that regulation is necessary in order to prevent the failure of systemically significant institutions; if there were ever a systemically significant institution it was Citibank, and of course the government had to step in to rescue it despite the fact that the bank was heavily and continuously regulated. So even if it were possible to identify systemically significant institutions, and even if we were willing to bear the competitive and moral hazard consequences of designating these institutions as too big to fail, we would still not be able to avert their failure through regulation. It would still be necessary for the government to step in and rescue them—at a cost to the taxpayers that would certainly be higher than if they had not been designated as systemically significant.

So even though the government has created moral hazard by rescuing some financial institutions, this is not a sufficient reason to regulate any financial institution as systemically significant. The argument rests on the erroneous idea—demonstrated every day in the current financial crisis—that regulation can actually keep institutions from failing. And if regulation will not prevent failure, why introduce the anti-competitive consequences, impaired market discipline and instability that will flow from—in effect—designating some entities as too big to fail.

Regulation of business conduct

Up to now, the discussion in this testimony has been confined to safety and soundness regulation—government oversight of financial institutions for the purpose of preventing their failure or the need for a government rescue. There is, however, another form of regulation—known as business conduct or consumer protection regulation. As its name implies, in this form of regulation the government sets standards for the behavior of businesses in dealing with the public. The SEC's rules on disclosure, the OCC's standards for how banks deal with the public, and the Food and Drug Administration's advance approval of pharmaceuticals are all examples of this kind of regulation. It has nothing to do with the financial condition of the company involved, but instead attempts to protect the public against specific kinds of harm. In the case of the SEC, the purpose is to make sure that the public receives adequate disclosure before purchasing a security; the OCC's rules assure that banks do not use their superior knowledge to overreach customers; and the FDA's prior approval process is an example of the government testing the safety of consumer products before they reach the public.

In each of these cases, the government is doing something that the public could not do for themselves—because they don't have the knowledge, the time, or the expertise. Under the securities laws, for example, there is no need for a company to make the same kind of disclosure to a sophisticated investor that it makes when it deals with the public. The reason for this is that sophisticated investors know the questions to ask and requiring a certain form of disclosure for them would be a waste of resources, and would raise the cost of capital for everyone.

This gets to the central question of when business conduct or consumer protection is necessary, and when it is not. Generally, as noted at the outset of this testimony, regulation is appropriate when there a great asymmetry of necessary knowledge between the parties to a transaction. Thus, a company has far better knowledge about the value of its securities than a member of the public that is being offered a share of stock, so the government seeks to redress this balance by requiring the company to make certain written disclosures to the prospective purchaser of its shares.

The mortgage meltdown has brought to light the fact that many people signed up for mortgages without understanding the nature of the obligation they were assuming. This seems to be a proper focus for regulation, even though anyone who has bought a home knows that there are already enough regulations to require paperwork several inches thick at every closing. Nevertheless, it would be useful to have a simple one-page form that would make clear to every buyer the relationship between his income and his monthly payment, and any increase in the monthly payment that might be in prospect. Licensing mortgage brokers might also be appropriate, just to be sure that they understand their obligations to the public when they sell a mortgage.

But there is generally no need to require regulation where service providers do not deal with the public, but at arms length with people who have the sophistication to understand what obligations they are assuming. For example, credit default swaps (CDSs) are transactions generally available only to sophisticated buyers. They would not be participating in the CDS market unless they were able to assess credit, and no one would want them as counterparties unless they were sufficiently strong financially to meet their obligations under a CDS. To regulate the transactions between sophisticated institutions in the CDS market would be a waste of resources. It would protect institutions that don't need protection, and should be allowed to fail if they do not understand the risks they are assuming.

Conclusion

Regulation is known to have severe adverse consequences in the form of impairing competition and innovation and raising consumer costs. Still, there are some cases where safety and soundness regulation—although often ineffective—is necessary, primarily where government backing of a financial institution eliminates or severely impairs market discipline. In these cases, regulation can be improved by making the activities of regulated entities more transparent. This functions as an enhancement of market discipline. Regulatory policies can also be structured so they are counter-cyclical, and thus tend to compensate for the human tendency to become euphoric about asset growth and to panic in an asset price decline.

Despite the frequent calls in the wake of the financial crisis for wider regulation of financial institutions that are not regulated today. There is no sound policy for doing this. Banks must be regulated for safety and soundness because they are perceived as backed by the federal government because of deposit insurance. But beyond banks and GSEs, which are similarly backed, there is no policy reason—other than preventing systemic risk—to prevent financial institutions from failing—even if regulation were capable of this. There is no evidence in the current financial crisis that systemic risk, in the sense that the losses of one spread to others and cause their failures in a kind of contagion, actually exists. But even if it did, attempting to designate certain entities as systemically significant would have severe adverse competitive results, impair market discipline, and increase taxpayer losses when rescues actually occur.

Professor WARREN. Thank you, Mr. Wallison. In fact, Mr. Wallison, I'll just come back to you, so you'll get a chance to talk some more.

I was struck by your comment when you said regulation doesn't prevent failures, see the recent bank failures.

Mr. WALLISON. Yes.

Professor WARREN. But I also listened to Ms. Raskin and Ms. Raskin, if I made my notes right, said in effect that federal regulators were captured and they really did a pretty lousy job whereas the state regulators were watching, the state regulators saw it, and they waved as many flags as they could. But failure seems to accompany those who are governed by regulators who are not independent or, to say it another way, non-regulation regulation seems to lead to failure.

Can you respond to Ms. Raskin's point?

Mr. WALLISON. Sure. I think I can. I have no faith, of course, as I suggested in my oral testimony, in regulators per se. I don't think they're any smarter than the people that they are regulating and in fact they are always relatively behind the curve. We assume that regulators are actually overseeing risk-taking, and they are not.

The only group that actually is interested in preventing risk-taking are creditors. Creditors are not benefited by risk-taking. And as a result, we ought to do everything we can to assure that creditors get the information about the risks that the institutions are taking so that they can make appropriate choices in lending money or withholding money from financial institutions, especially regulated institutions.

Professor WARREN. Sir, I just want to make sure I'm understanding the point. Regulators are not smart enough to regulate or they simply won't regulate?

Mr. WALLISON. Oh, I think they would love to regulate. In fact, they—for the larger institutions here in the United States, the larger banks, there are regulators in those institutions 100 percent of the time.

Professor WARREN. Maybe that was Ms. Raskin's point.

Mr. WALLISON. Yes, of course, but I'm saying that no regulation is going to be satisfactory if we are relying simply on government people going in and looking at what the institutions are doing.

The ones who are really effective at regulation are the ones who have the incentive to do so, I believe, and those are the creditors, the people who are asked to lend the money or make deposits in those institutions or be counterparties in transactions. They need the information that they are not getting from the institutions to decide whether risks are being taken.

Professor WARREN. Ms. Raskin, maybe I could give you a chance to respond as a regulator.

Ms. RASKIN. Yes, thank you. I do believe that regulation works. I think that there are systems in place currently that primarily permit a great deal of coordination between state regulators and federal regulators.

We have seen through recent history that regulators have been very nimble at the state level, have been very precise in dealing with the problems that have arisen, particularly the number of foreclosures, that we've been dealing with on a massive level at the state level.

So I do believe that regulation works. I urge, though, the panel to consider when they design a new system for organizing the regulatory boxes that checks and balances be considered, that accountability be built in and that mechanisms be adopted that permit coordination among the different regulators.

Professor WARREN. President Seligman, I have the sense you'd like to respond to this.

Mr. SELIGMAN. Effective regulation can increase confidence in our markets. We've seen, for example, during the time of the SEC the percentage of investors in this country grow from 1.5 percent to approximately 50 percent, the value of equity and debt in this country grow from 90 billion to close to 12.6 trillion.

At the same time what you referred to as non-regulation regulation can undermine this confidence and the classic recent illustration that has so far been reported upon is Bear Stearns where you had too few individuals involved in administering the SEC's Consolidated Supervisory Entity Program. When problems were flagged, they did not go up the chain of command. You had certain wrong rules, and I commend to your attention the report of the SEC's Office of Inspector General on Bear Stearns which documents that you have to have people who believe in regulation to administer it if you're going to in turn prevent financial misconduct.

Professor WARREN. Thank you very much. I'm nearly out of time. So I'm going to go to Congressman Hensarling.

Representative HENSARLING. Thank you, Madam Chair. I again thank the panel.

Mr. Wallison and Mr. Sumerlin, I think you both wrote about Fannie and Freddie in your testimony. I'm not sure I heard it or saw it in the other testimony.

Mr. Wallison, in your testimony, you speak about Fannie and Freddie were largely responsible for the vast inflation of the housing bubble, and Mr. Sumerlin, I believe you write in your testimony that the GSEs, Fannie and Freddie, encouraged loans to people who could not afford them and essentially helped destabilize our housing market in direct contrast with their mission.

I would like to give you two gentlemen, starting with you, Mr. Wallison, an opportunity to elaborate on your thoughts on precisely the role of Fannie and Freddie in our economic turmoil and also speak, if you would, specifically to their affordable housing mission. Mr. Wallison.

Mr. WALLISON. Fannie and Freddie represent an effort on the part of Congress to achieve a national housing goal without appropriating funds. Instead, what Congress did was used two private companies to make loans that they might not otherwise have made, except for certain housing goals that they were required to meet.

As a result, Fannie and Freddie contributed about 40 percent of all the subprime and Alt-A loans that we are currently struggling with in our economy by buying loans from originators that would not otherwise have been marketable. That distorted our financial system and has ultimately been the cause of the tremendous losses that we are going to suffer in housing.

Representative HENSARLING. Mr. Sumerlin.

Mr. SUMERLIN. During the 1990s, both of the GSEs continually lowered their downpayment requirements of what type of loans they would buy.

Now, when the loan went below a 20 percent downpayment, it still had to have some form of mortgage insurance, but loans were being securitized through Fannie and Freddie that did have lower and lower downpayments. This is, as you know from my testimony, something that I believe is a problem when you have excess leverage to homeowners.

During, the peak of the housing boom, they were operating, just as were private firms, in buying and thereby aiding mortgages that should never have been given. I think the GSEs, given their link to government, do tend, when they do something, to put more of a stamp of approval on it, than when other people do and therefore they had a special role to be even more diligent and the GSEs had—from the beginning, were undercapitalized and had an incentive problem where they could essentially privatize profits and socialize losses and that's the framework for taking on——

Representative HENSARLING. Is it your opinion that but for their government sanction duopoly status that they would not have been able to do what they did?

Mr. SUMERLIN. They certainly would not have been able to do what they did with the scale they did. I mean, they existed on that scale because of their link to the Federal Government.

Representative HENSARLING. Mr. Sumerlin, also in your testimony, you speak extensively, I believe, on the Federal Reserve policies, particularly in dealing with our last financial crisis after the dot-com bubble and 9/11, and I think on Page 8 of your testimony, I had not realized this, for three straight years, the Fed fund rate was essentially negative, as you put it, the equivalent of free money.

I think there was a body of work that would suggest that the seeds for this financial crisis were, frankly, sown in trying to deal with the aftermath of the last financial crisis.

Would you speak a little bit more extensively about your view of the role of the Federal Reserve's easy money policy enabling the crisis that we find ourselves in?

Mr. SUMERLIN. I think that once you get yourself into a boom-bust cycle, you start doing emergency policies and other things to mitigate the current problems and you don't always know where you're going to end up.

Once we had the enormous tech bubble where the PE ratio, the S&P, for instance, got up to 45, about three times its historic average, and then in 2001, when—starting in March of 2000, we had about $5 trillion in asset losses and the government starts to react to that, and deflating asset bubbles can be very vicious economic events, and part of the reaction to that was the Federal Reserve from 2002–2003–2004, real interest rates, meaning adjusted for inflation, were effectively zero, which is like free money.

Part of the other issue was the Federal Reserve, by being completely transparent that it was going to take a very gradual path that lowered bond volatility. Volatility, and other sort of things, which encouraged financial entities to take on more risk and in some cases, some financial entities, like pension funds insurers, they need a seven percent, eight percent nominal return, and when you're operating in a very low nominal return world, they start to leverage up to try to hit the return they need to meet their internal targets.

Professor WARREN. Thank you, Mr. Sumerlin. Thank you. We're over time. Congressman, thank you.

Mr. Silvers.

Mr. SILVERS. Thank you, Madam Chair. President Seligman, I understand you have some time constraints here. I would appreciate it if you would in writing advise us as to specific steps to strengthen the Securities and Exchange Commission in light of your testimony. Specifically, though, my question to you is there's been some talk about unified consumer protection financial services in a regulatory body.

Do you view the types of substantive consumer protection that we see in insurance, mortgages, credit cards, as being easily mergable with the sort of disclosure-based investor protection that the SEC does?

Mr. SELIGMAN. I think it's a tough analysis that has to be done. I do think, for example, a potential merger of the SEC and CFTC makes good sense for a number of reasons. I do think there needs to be very thoughtful analysis as to whether or not certain aspects of insurance should be subject to federal regulation.

I do think, however, that when you try to create one consumer and investor agency across the board you risk dissipating the expertise necessary to effective regulation and what I'm very much concerned about when I look at the experience, whether it's of the SEC or other agencies, when their mandate becomes too broad, they tend not to be able to focus on everything equally well. There is a real value to expertise.

The countervailing challenge, and it's been well illustrated in the recent past, is regulatory arbitrage and, for example, when you have five depository institution regulators, the ability of those regulated to pick and choose which format they'll be subject to does create a kind of tendency towards a race to the bottom.

So it's going to take very, very systemic analysis. It shouldn't be done quickly. You need to have sufficient hearings. You need to have sufficient reports so you can reach the appropriate outcomes.

Mr. SILVERS. Thank you. Ms. Bloom Raskin, you are the only member of our panel who is actually involved in the housing crisis and the foreclosure crisis in any direct way right now in your capacity.

Can you shed light on the relative responsibility in your view, based on what you've seen, of the GSEs and GSE-financed mortgages on the one hand and of the non-GSE entirely private sector firms on the other that were so much encouraged in the last eight years?

Ms. RASKIN. I'd be happy to and that's—it's an excellent question.

What I can speak to certainly is the work that we have been doing in Maryland regarding the foreclosure crisis and we identified quite early that mortgage servicers were in fact a linchpin to working through a lot of the problems of loan modification and the need for sustainable mortgage modification, and to that extent, what we have done, and I think states are very well positioned to do, is to work individually, and it's hard work, it's a lot of heavy lifting, but to work individually with mortgage servicers which we have done.

We have hammered out agreements one by one with them in which we require certain operational fixes being made within the relationship between the borrower and the servicer and we have worked very hard in that regard.

We have also put in place a monthly reporting system by which we collect data on a monthly basis from the mortgage servicers that are doing business within our state and in this way we have been able to track modification efforts and we've been able to measure the sustainability of those modifications.

This to me are—these are two examples of how we have been able to work on a local level without really the involvement of the GSEs and Fannie and Freddie but with the servicers over whom we do have some regulatory authority.

Mr. SILVERS. Thank you. Professor Stiglitz, in your written testimony, you raised a question of whether the Federal Reserve as currently structured is an appropriate umbrella regulator.

I think, Mr. Sumerlin, you also have some concerns about the Fed in your testimony you gave this morning.

In order, Professor Stiglitz, could you comment on what changes might be necessary to the Fed for it to play the role some envisioned for it?

Dr. STIGLITZ. First, let me say I share the view of several people on the panel that the Fed was too easily captured by the spirit of the bubble that was going on. The metaphor that was given of a punch bowl that was spiked is, I think, absolutely correct.

That's why I think it's important to make sure that the Fed becomes more representative and much more explicit about its mandate. In the United States and around the world, there has been focus only on inflation. There have been explicit discussions not to worry about assets and I think Mr. Sumerlin is exactly right, that the Fed needs to understand that financial instability is far more of a risk for long-term economic growth than an increase in inflation from two percent to 2.5 percent.

Professor WARREN. Can I ask you just to wrap up just because we're over time?

Dr. STIGLITZ. Okay. The single most important thing is to make sure, like they do in Sweden, for instance, that there are representatives on the Federal Reserve Board of people whose views may not be quite consistent with those in the investment community, such as from the labor community.

Professor WARREN. Thank you. Senator Sununu.

Senator SUNUNU. Thank you, Madam Chair. Listening to the testimony and some of the answers to questions, I want to begin with an observation. I believe that Mr. Wallison's point—that even in areas where he would agree that regulation should be imposed because of a government guarantee, the regulators can still cause significant problems—is not at odds with the points made by Mr. Seligman and Mrs. Raskin.

In fact, I think the points that you made reinforce this point. There may be other areas where there's disagreement, but the example of the SEC's Consolidated Capital Rule, and the example of regulatory capture—and let's name names, at the OTS—these are two of the oldest and, one might argue, most experienced federal regulators that took specific action or failed to take specific action that made this crisis much worse.

I think we need to be cognizant of that and actually use that as a basis for the recommendations that we make. I also think that speaks directly to Mr. Wallison's concern about the way in which existing regulatory structure can make the problem worse. Now, they could also help deal with problems, and I believe that they should.

I'd like to go to Mr. Seligman, though, not to talk about the CFTC/SEC consolidation to which I'll come back. You mentioned something else—a federal voice for insurance regulation and the concept of a federal charter, an optional federal charter for insurance, which the Treasury Blueprint also discussed.

How do you think that a federal voice for insurance regulation might work? Do you think it's necessary, given the national scope and the global scope of some of these insurance companies that we see today? AIG is obviously high profile but there are many others. But equally important to the other panelists, those in closest proximity to you, can we still maintain a meaningful voice for state regulation in an environment where we have an optional federal charter or federal insurance charter?

Mr. SELIGMAN. I think there are two separate reasons you should look hard at a new federal role with respect to insurance.

The absolutely imperative one now is systematic risk; that is, there are aspects of at least certain insurance corporations which required ultimate federal rescue packages which, because of counterparties, were viewed as of similar consequence to commercial banks and investment banks.

There is a separate point, and that is that insurance regulation may be anachronistic. It is the only major financial sector which is essentially purely at the state level. This creates, among other things, potential competitive disadvantages in the global economy. It creates the kind of problems that the Securities Acts in the 1930s or certain of the banking legislation has addressed through preemptive mechanisms and federal mechanisms.

It seems to me what we ultimately would be most wisely moving towards was federal insurance regulation above certain thresholds, perhaps on an optional basis but more wisely I would suggest on a mandatory basis, through a chartering mechanism and state insurance regulation on a residual basis, the way you have it in——

Senator SUNUNU. Mandatory based on the aggregate assets of the insurance company or mandatory based on the size of the policy?

Mr. SELIGMAN. I think that is the kind of question we need to systematically review. I don't want to shoot from the hip on it, but I will suggest to you that I know there are a number of leaders of major insurance companies right now who would suggest to you that it is easier to deal potentially with one federal regulator than 55 state and similar regulators that they now have to address and that to have one set of standards would potentially give them competitive advantages in a global economy.

Senator SUNUNU. Do you still see a role for meaningful participation by the states to provide——

Mr. SELIGMAN. Absolutely. State securities regulation is absolutely vital for a number of reasons. It enhances the enforcement. It deals with local problems. It is a laboratory by which new ideas can originate, but at the same time for firms, either in interstate commerce or above certain thresholds, the notion that we would continue to rely on state securities regulation today would be dysfunctional.

Senator SUNUNU. On the recommendation that the SEC and CFTC be combined, what do you—and I know this is an area where you've done a great deal of work—but what would you identify as the most specific obstacles to combination and how do you recommend we overcome those obstacles?

Professor WARREN. And since we're out of time, could I ask for just a condensed answer since I know this is in your testimony?

Mr. SELIGMAN. Very simply, in a sentence, that the oversight committees in Congress for securities and commodities regulation are separate.

Senator SUNUNU. It's a turf war.

Mr. SELIGMAN. It is a turf war. It is not principled. It is not wise.

Senator SUNUNU. I don't know if that makes the problem of consolidation easy or more difficult.

Mr. SELIGMAN. Unfortunately, you do know.

Professor WARREN. Thank you. Thank you, Senator.

Mr. NEIMAN. I'd like to stay with Professor Seligman and follow up on your ideas for the role of the Federal Reserve as an apex agency, as a systemic regulator.

If you could expand upon that as to why the Federal Reserve is the appropriate entity, and how would it operate differently than we are seeing the Fed operate in our current environment?

Mr. SELIGMAN. It has been the emergency entity since at least the 1987 market crash time after time. What it doesn't have is the right information flows, confidence in the underlying examinations, so that it can anticipate problems and try to obviate risk.

You have three choices ultimately: the President's Working Group, the Department of the Treasury, or the Fed. The Fed has been the one that operationally seems most competent to address this.

What you want is not a Twin Peaks Model which suggests that at a similar level you both have safety and solvency and investor/consumer protection. What you want is a very different type of approach where you have one agency that unequivocally receives all relevant information and can address systematic risk and respond to it the way the Fed implicitly has been doing for some time now but properly armed so that they've got confidence in information flows.

And second, then you want to preserve industry expertise in a series of agencies. While it's a very crude and imperfect analogy, what was done with intelligence services after 9/11 where you have a national intelligence director but separate intelligence agencies is a better model than the Twin Peaks.

Mr. NEIMAN. Thank you. Mrs. Raskin, it's a pleasure that you were able to join us and have a fellow regulator here and in fact it's probably a unique experience where a panel is made up, the sole regulator is the state regulator. So welcome.

Some have suggested that the dual banking system might make it more difficult to prevent or manage crises and to Mr. Seligman's point, the response to 9/11, we moved to a more coordinated approach by creating a consolidated agency.

Is that comparison apt? And what are your thoughts on the risks associated with moving toward a consolidated approach, the opportunity if you had a single regulator of missing red flags and eliminating checks and balances?

Ms. RASKIN. Well, I think it's a very apt analogy and I think that the dual banking system has actually been the savior here in mitigating even greater harm that could be coming from the financial crisis that we are now all living through.

So I believe that the checks and balances that are in place by virtue of that system are a good example and a good model for study as we move forward in deciding what a regulatory, a new regulatory system might look like. So I do think that the state examiners, the state supervisory role has been an important check. I think that state-chartered institutions, by virtue generally of their size, have been able to be a good shock absorber to a lot of the systemic risk consequences we've been experiencing.

Mr. NEIMAN. Thank you. Dr. Shiller, I was very interested in your concept of the continuing work-out loan and would probably want to follow up with you after, but in the minute we have left, have you done any analysis or research around the unintended, possible unintended consequences of that in terms of impact on the market, the ability of lenders to hedge their risk? Could it result in higher interest rate loans, shorter-term loans, and what would be the impact and expected reaction to the marketplace?

Dr. SHILLER. Well, my proposal is a market-based solution and it involves the government only as a regulator that would make this possible.

You're asking questions that are difficult. How would market prices be impacted by an institution like this? In terms of mortgage rates, it's possible that a continuous work-out mortgage would have a higher interest rate because you're getting some kind of insurance, but it shouldn't be considered a bad thing if people have to pay a higher interest rate. They're getting a kind of risk protection.

But on the other hand, we don't know how much higher because it affects the whole economy and the whole systemic risk to the economy. So having something that protects mortgage borrowers built into the initial mortgage improves the resilience of the whole economy and in the long run it might produce even lower mortgage rates.

Mr. NEIMAN. Have you seen any other jurisdictions, countries, or financial institutions that have adopted it?

Dr. SHILLER. This has not been adopted in any country as far as I know, but we are coming into a new century and things have to change and I think it's entirely plausible that as our financial markets develop, we will build in more protections for people and this is the trend we've seen in the past and I expect it to continue in the future.

Mr. NEIMAN. Thank you.

Professor WARREN. Thank you. Thank you, Mr. Neiman. We're going to do a second round of questions, if you'll bear with us, and I wanted to start, if we could, with Dr. Stiglitz.

I was captured by your remark and I know there's a reference to it as well in your testimony, that TARP has failed and it has failed in part because of the failure to put any conditions on how the money has been distributed. And you talk about the counter factual. If we had taken $700 billion and simply infused it in a new institution, how the world would look a little different right now.

You make the point about imposing conditions on extending TARP funds. Can you just elaborate on that, Dr. Stiglitz? What would be your top three recommendations?

Dr. STIGLITZ. Yes. I listed in my testimony a number of recommendations. Obviously, there's broad consensus that the notion of our pouring money into these banks and having the money pour out in the form of dividends or bonuses, or in the form of acquisition of other healthy banks does not lead to more lending. That would be an obvious condition.

A second set of conditions is that there are a large number of practices that everybody has identified as having contributed to the problem: Bad incentive structures, bad lending practices, exploitive anticompetitive practices in credit markets, and predatory lending.

We are now in effect partial owner of the banking system of these large banks and yet we're like a "slum lord." We're condoning these actions by providing money and allowing the banks to continue some of these very bad consumer and investor practices.

A third thing I would do picks up on what the Commissioner said. We have some banks that are in better shape than others. These are the banks that actually were spending more of their time actually lending to small- and medium-size enterprises. These include community banks and many of the banks that are regulated by the states.

They should have been the ones getting a disproportionate share of the money, not the banks with gambling propensities that have proven their incompetency or those that prided themselves on having moved out of the "storage" business and lending business into the moving business.

We've been subsidizing this moving business. We should have been focusing on lending and asking what parts of the financial sector will get the flow of credit restored. Finally, we need to do something about the foreclosures.

Professor WARREN. Good. Thank you. That's very valuable. Thank you.

I want to ask, and I'll spread this across people, if you have different thoughts, to talk about the massive failure in the credit rating agencies that gave us the AAA ratings to instruments with enormously high risk, these private credit rating agencies that the government simply embraced and gave legal consequences to that.

Can you speak to structurally how we might alter that, how we might think about a different way to do this? Did I see you shake your head no, President Seligman?

Mr. SELIGMAN. No, I didn't mean to shake my head no, but what I—you have a Hobson's choice at the moment. You either are going to have credit ratings paid for by users or providers. We have a system where credit ratings at the moment are paid for by providers. It creates a conflict of interest. It does create a situation where the oversight until very recently has not been as systematic as it should be.

You now have the SEC engaged in a catch-up effort with a significant report recently and some proposals which will be considered in the next Administration.

The choices that are also on the table that you may want to think about, one has been the notion of the SEC placing less reliance on credit ratings and before we go there, we have to think through very carefully what happens then. That will mean more reliance in effect on those who provide information to the marketplace and not having any outside evaluation.

Second, the notion of the government being engaged in credit rating strikes me as not a thoughtful or appropriate one for the same reasons that we rejected merit regulation in the 1930s in the securities industry.

Professor WARREN. Dr. Stiglitz, could you add on this?

Dr. STIGLITZ. Yes, I think that it is a very difficult problem. The current system is flawed in the incentives that underlie the way the credit rating agencies work. They were also very much taken up with the same flawed models that the banks were using, and so it was partly their incentives and partly their analytic frameworks.

In other areas, like medicine, we rely on governments to rate products and see whether they are safe enough to be used and to identify the circumstances in which they can be used.

It seems to me that that analogy is appropriate for financial products as well.

Professor WARREN. Thank you very much. We're on time here. Congressman Hensarling.

Representative HENSARLING. Thank you, Madam Chair. Professor Shiller, I actually—your book on the Subprime Solution is one of six presently sitting on my desk. I haven't read it yet. I look forward to reading it. At least you made a few bucks off of me.

I think I heard in your testimony, I think you said that you advocate federal subsidies of financial literacy, and I certainly share your enthusiasm for the broader subject of promoting financial literacy within our country. I'd probably prefer the incentive structure as opposed to the subsidy structure.

But I ask the question. As there are various policy proposals pending within Congress that some would argue would essentially bail out a huge universe of borrowers who may not have known about the mortgage products that they signed up for, maybe they should have known, but what incentive do they have to become financially literate if we essentially absolve them of personal responsibility?

Dr. SHILLER. Well, I think we are going through a national tragedy right now of foreclosures and in many cases these people didn't know what they were getting into and so I think that part of our civil society is that we have to bail out many of these people. But

I think that it's really important at this time to think about the longer term and to think about how we can change the system.

Right now, we have a system in which most people get no financial advice from a disinterested party. They get advice from sales people of one sort or another who have an incentive to sell them their product.

What I would like to see is a system in which people are getting advice from someone who signs a statement of loyalty to the client and announces that he or she will not take commissions or kickbacks of any form and that this would be a long-term relationship a person could develop, like with a physician but with a financial advisor, who you could go to and say should I really take this mortgage, is this really good for me?

That's something that is a costly thing. I think the government should subsidize it and that it would ultimately improve the whole atmosphere of——

Representative HENSARLING. Well, and again, I share your enthusiasm for financial literacy, and I certainly can't do it justice, but I know Thomas Jefferson at one time said something along the lines of if you disagree with how your neighbor is acting within the marketplace, we shouldn't try to restrict his freedom, we should inform his discretion.

So I certainly agree with that, but it seems to me when it comes to financial literacy, there would be no greater course than actually having foreclosure proceedings initiated against you and yet we know that even those who are having their mortgages reworked under various programs, the repeat rate of default, I believe and I don't have the statistic at my fingertip, is somewhere in the neighborhood of 40 percent. So that's still somewhat question. I'm not sure there could have been a more effective course in financial literacy than that.

If I could, let me change subjects here. Mr. Wallison, in your testimony, I don't think we've touched upon this subject previously, and that is the subject of mark to market.

Certainly again as a philosophical and principle position, I believe that more transparency is better than less transparency. I think the opaque quality of a number of these very complicated investment vehicles have exacerbated our problem, but how do you mark something to market when there isn't a market, and isn't the accounting rule itself that's the problem or is it really the intersection of mark to market with certain of our regulatory capital standards?

Mr. WALLISON. Well, Congressman, it's both in a way. The reason I mentioned mark to market in my prepared remarks is that the problem we have today is that fair value accounting is a problem when there is no market, but it's also a problem when there is a market. It's highly pro-cyclical. When asset values are going up, it is possible to write up your assets and look much more profitable, borrow that much more money and increase the bubble that is developing.

On the way down, when everyone is panicked and running for the doors and doesn't want to buy anything, then fair value accounting works in the opposite direction and——

Representative HENSARLING. In the five seconds I have left, what would be your proposal?

Mr. WALLISON. Well, I think we ought to modify fair value accounting so that it tends to be counter-cyclical; that is, when assets are going up, it should not allow increases in asset values on balance sheets, and when asset values are falling, when there's a panic going on, we should limit the degree to which they can be written down, or have to be written down; or allow institutions to treat these assets as held to maturity which is a much safer way to value these assets.

Representative HENSARLING. Thank you.

Professor WARREN. Thank you. Mr. Silvers.

Mr. SELIGMAN. Could I just add one——

Professor WARREN. Yes, President Seligman.

Mr. SELIGMAN. You might want to take a look at a very recently-released SEC Office of Chief Accountant Report on Fair Value Accounting which does focus on impairment issues. It's actually somewhat similar to some of the points that Peter Wallison just made.

Professor WARREN. Thank you, President Seligman. Mr. Silvers.

Mr. SILVERS. Thank you, Madam Chair. There have been several comments made in the written testimony and I believe this morning by panelists about the issue of incentives and particularly in relationship to executives of institutions that are "systemically significant," where there may be a public guarantee of some sort sitting around.

I'd be curious to know. I am familiar with the recommendations from the Aspen Institute on both time horizons and symmetry, avoiding asymmetry in compensation. I would hope the panel might comment for a moment, starting with Professor Seligman, on both are these good ideas and how would one implement them in a regulatory and tax structure.

Mr. SELIGMAN. I'm not clear precisely what the specific recommendations you're referring to. If you want to focus on executive compensation which——

Mr. SILVERS. I'm interested in executive compensation as an issue of incentives around time horizons and around asymmetry, meaning the incentives to take large risks if you're not fully exposed to the down side.

Mr. SELIGMAN. We have seen throughout the 1990s and into the 21st Century clear problems with respect to executive compensation, ranging from the initial treatment of stock options some 15–16 years ago. The back-dating of options has been a scandal and it's being referred to in a number of enforcement cases, but it got way out of hand. Disclosure and the ability of shareholders to understand what compensation levels are is a perennial challenge and there have been proposals, including by the President-elect, that there should be at least advisory votes on the part of shareholders to address this area.

It's one that requires attention. It's one that I think should be clearly on the priority list for the SEC as it comes into its new Administration.

Dr. STIGLITZ. I think it's very clear from any analytic perspective that the incentive structures that are commonplace do encourage short-sighted and excessive risk-taking behaviors.

I think it would be easy, for instance, to base pay not on performance in one year but on performance over a longer time. Making a longer-term horizon would be a relatively easy change.

Let me just emphasize one more point, which is that when pay is related to stock performance, it has a further effect of encouraging bad accounting standards. That was what we saw in Enron. It was not fixed in Sarbanes-Oxley, and so the problems go deeper in that these incentive systems actually encourage distorted information, which really undermines the transparency, efficiency, and confidence in our economy.

Mr. SILVERS. Secondly, the panel—much of the testimony we've heard this morning has talked about regulatory gaps.

I would like panelists to react to the proposition that we ought to regulate activity based on what it is economically and that we ought to have transparency requirements, accountability requirements, and capital requirements in relation to that activity based on what it is. If it's insurance and we call it a credit default swap, perhaps we ought to regulate it like insurance.

Comments?

Mr. SELIGMAN. You know, I thought the point of the GAO report makes sense. Start with what are your objectives and if part of it is systemic risk avoidance and reduction, then the gaps are seen in a particular perspective. You simply can't afford to have large hidden aspects of our economy, whether it's credit default swaps or other aspects of OTC derivatives, hedge funds, or what have you, and that strikes me as one way in which you get at this.

A second issue, though, is almost the behavioral arbitrage issue; that is, in effect if you're a hedge fund manager, you're unregulated, but if you're an investment advisor, you're regulated by the SEC, you create an incentive structure to move towards the unregulated segment of the economy and you, frankly, frustrate the ability for examination and understanding what's going on.

I suspect, though I do not know for sure, that when the ultimate books are written on Bernie Madoff, you will discover that most of the activity took place not in his registered broker-dealer operations but in "exempt investment advisor or hedge fund operations," and in effect this was an example of behavioral arbitrage where you had someone move to unregulated areas and we saw in retrospect a very large price was paid.

Professor WARREN. Thank you. Senator Sununu.

Senator SUNUNU. Thank you.

Professor WARREN. Thank you, President Seligman. I know that you have a plane to catch. We appreciate your being here and you are excused. Thank you.

Senator SUNUNU. Mr. Wallison, you talked about devising regulation that was counter-cyclical and you mentioned the requirements or rules regarding accounting for assets as an example.

Could you give a few other examples of recommendations that you would make that you think could be implemented realistically in the next few months that would also reinforce this counter-cyclical approach to regulation?

Mr. WALLISON. I think the central problem of pro-cyclicality is a problem of human nature. We are always euphoric when things are getting better, when asset prices are going up. We then become very negative when things reverse and asset prices are going down. Regulators are going to be subject to the same problem; that is, when things are looking good, they are not going to stop the party, even though they are supposed to take the punch bowl away. They will not stop the party. Congress doesn't want them to stop the party.

We should have a law that requires the regulated institutions to add capital at a time when asset prices are going up, when things look very good.

It's kind of a counter-cyclical capital requirement—not the kind of capital requirement we have in prompt corrective action, that the FDIC enforces for banks, where they require increasing institutional restrictions as capital declines. This would be increasing capital requirements as the institutions become more profitable, because we know that at some point in the future, things will reverse, the bubble will burst, and we are going to be faced with institutions not having enough capital.

Senator SUNUNU. Would you interpret the risk-weighted capital approach of Basel II as being pro-cyclical in this regard?

Mr. WALLISON. You know, there are so many things wrong with Basel II,——

Senator SUNUNU. Okay.

Mr. WALLISON [continuing]. I don't even want to——

Senator SUNUNU. I only have two and a half minutes here.

Mr. WALLISON. Yeah.

Senator SUNUNU. That's fine. We can talk about that later and develop some comments for the record.

Mr. WALLISON. Okay.

Senator SUNUNU. Mr. Sumerlin, you talked about capital standards and having them binding, having them clearer, less subject to subjective interpretation.

Can you expand on that a little bit, talk about what kind of a system for setting capital ratios would make sense, what kind of changes we need to make, and whether those capital ratios should be based on institutional activity or size or other parameters?

Mr. SUMERLIN. I mean part of how I look at this is I look at what regulations do I think worked and I think the leverage ratio of the FDIC was helpful.

It would work in a similar way to what Mr. Wallison described where, if during good times you wanted to buy a lot more assets, you'd have to put in more capital and, you know, my preference for regulation is I like it to be blunt, simple, enforceable, and to be sort of a backstop and so that you don't discourage sort of the types of new innovation that Mr. Shiller's talking about, but there is something there that catches you and says no, you don't get to lever up 50:1 and that's why I like this very simple leverage ratio just because I think it did prevent what might have been broader problems during a bubble.

If I could just make one more point on the mark to market idea? You know, my own view is there is a price for everything and that price sometimes might be zero and you might not like it, but there is a price.

Now, with mark to market, I think one of the problems with it is it's a point estimate and so I would favor some sort of lengthening of time where you're averaging prices over a longer period and that would smooth out in both the upside and the downside, and if you look at even quarterly accounting right now what happens when a bank has to report its quarterly earnings, it will expand its activities in between the quarter and then they've got to get the balance sheet down, get the balance sheet down, get the balance sheet down for the report and so we do need to get away from sort of the snapshot in time type of——

Senator SUNUNU. Let me ask you one question about a statistic I think you used in your testimony, but it came as a shock to me, even having looked at a lot of this material. It was that in 2005 43 percent of the people in America who purchased a home with a mortgage put no money down.

Mr. SUMERLIN. Forty-three percent of first-time homebuyers.

Senator SUNUNU. In 2005, 43 percent of all first-time homebuyers.

Mr. SUMERLIN. Of all first-time homebuyers.

Senator SUNUNU. Put no money down.

Mr. SUMERLIN. Yes.

Senator SUNUNU. To the best of your knowledge, did any state or federal regulators anywhere prohibit that or try to create a regulation that might have discouraged that kind of behavior which I think most people would fairly describe as somewhat speculative?

Mr. SUMERLIN. I'm not aware of it. There's nothing that worked. I'll put it that way.

Senator SUNUNU. Ms. Raskin, do you know of anything that might have——

Professor WARREN. Senator Sununu, you're over time now.

Senator SUNUNU. I wanted to give her a chance to respond. She might have better information——

Professor WARREN. Sure.

Senator SUNUNU [continuing]. Than Mr. Sumerlin.

Ms. RASKIN. Clearly that practice has all but evaporated, truth be told. The good thing, I think, is that a lot of states have now passed laws that prohibit what are called stated income loans, loans in which there is no documentation at all provided and there's no basis upon which the borrower has shown an ability to repay.

Senator SUNUNU. Thank you.

Professor WARREN. Thank you. Mr. Neiman.

Mr. NEIMAN. Thank you. Dr. Stiglitz, in your testimony you talk about the idea of ring fencing, to put greater standards in place for systemically-significant institutions and commercial banks that serve consumers and pension funds, and separating those out from business activities that serve high net worth and capital markets activities.

Can we draw such a bright line? Is that function—is it practical, and I'd like you to just kind of elaborate on how that would actually be implemented or deployed?

Dr. STIGLITZ. It can't be perfectly implemented, but I think it's absolutely necessary that we do something along those lines because we can't be fully comprehensive in our regulation. Our financial markets are too complex.

On the other hand, we know that we have to have far better regulation of our commercial banks, which are systemically important. If we don't, the system will have another crisis, such as the one we currently have.

We have to move towards some degree of ring fencing. In a way we do that already; that is to say, we don't want our banks to invest too much in a gambling institution or something like that.

The question is can we go further, and I think the answer is clearly yes. If we have an unregulated, highly-leveraged institution, like a hedge fund, operating out of a secret bank account, we should say to the banks that they should not be lending to those kinds of institutions, which are supportive of corruption and tax evasion.

This is a matter of degree, but I think we can work much more towards ring fencing these core financial institutions.

Mr. NEIMAN. Thank you. Mr. Wallison you've written a lot about the role that CRA and the GSEs have played in contributing to the crisis, and as you probably would not be surprised, I come at it that the CRA was not a contributor and the data that I have seen in terms of origination showed the majority of those originations came from non-bank entities who were not subject to CRA.

Have you seen or are relying on data that would support your basis of the role that CRA played in contributing?

Mr. WALLISON. The role that CRA played in contributing to our current problem was simply a role in reducing the quality of the mortgages. That's why we got to the point where Marc Sumerlin was mentioning that 43 percent of the people who bought homes initially in 2005 had no downpayment. The purpose of CRA was to force banks to make loans to people who could not otherwise get mortgages.

I believe that we should have a homeownership policy, as we do in this country, and it might require subsidies. But in the case of CRA it just required banks to make loans they wouldn't have otherwise made, and that forced them to reduce the quality of the mortgages. It's the only way they could do it. And so, what began with CRA continued through the rest of the economy. It was picked up by all kinds of other people who were making loans, unregulated lenders as they are called, and Fannie and Freddie bought many of those loans, over a trillion dollars of those loans. $1.6 trillion of these bad loans are on Fannie and Freddie's balance sheet.

It is not CRA——

Mr. NEIMAN. How much?

Mr. WALLISON. $1.6 trillion of subprime and Alt-A mortgages are on Fannie Mae and Freddie Mac's balance sheets.

Mr. NEIMAN. Subprime and Alt-A?

Mr. WALLISON. Subprime and Alt-A. That's right.

Professor WARREN. These are not originations, though.

This is including the amount that they were required to buy later on, is that right?

Mr. WALLISON. They were required to by their affordable housing regulations to buy these mortgages.

Professor WARREN. Not by the regulations. They've been required by Congress to purchase.

Mr. WALLISON. Well, through the affordable housing regulations, Congress——

Professor WARREN. No.

Mr. WALLISON [continuing]. Did not insist on——

Professor WARREN. No, not through originations. That's the question I'm asking about trying to sort this out. I'm sorry, Mr. Neiman.

Mr. WALLISON. My whole point is simply that CRA did not add materially to the number of such mortgages. They were very small, about three percent. What CRA did was start the process of making mortgages of lower quality and that's the central problem we have today.

It is true that we've had a big inflationary bubble because, perhaps, of the low interest rates that the Federal Reserve approved for a long period of time. But what's different about this bubble is that the mortgages that are causing problems are very poor quality mortgages. Otherwise, we wouldn't have this financial crisis.

Mr. NEIMAN. Just to follow up on one point, the way we've seen it operating throughout neighborhoods throughout the country, is so much of that was originated by non-bank entities, not subject to CRA. I'm not making any apologies for the large commercial banks, investment banks, who participated—who funded that through the securitization process, but it was not CRA that was driving that. It was the securitization process and the misaligned incentives and over-reliance on credit.

Mr. WALLISON. And Fannie and Freddie bought them.

Professor WARREN. I want to thank you all for being here. I have special thanks that I need to acknowledge publicly to the Senate Committee on Commerce, Science and Transportation for lending us this lovely room for our hearing, but I especially want to thank all of our witnesses for coming.

Mrs. Raskin, Dr. Shiller, Dr. Stiglitz, Mr. Sumerlin, and Mr. Wallison, we appreciate your taking the time to prepare your testimony, to come here, and I hope you will be willing to answer questions that the panel submits in writing and have those questions be on the record.

We appreciate your help very much and with that, this hearing is adjourned.

[Whereupon, at 11:40 a.m., the hearing was adjourned.]

○