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REGULATORY RESTRUCTURING AND REFORM OF THE FINANCIAL SYSTEM

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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CONTENTS

REGULATORY RESTRUCTURING AND REFORM OF THE FINANCIAL SYSTEM

Tuesday, October 21, 2008

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Maloney, Velazquez, Watt, Ackerman, Meeks, Moore of Kansas, Capuano, McCarthy of New York, Lynch, Scott, Green, Cleaver, Bean, Moore of Wisconsin, Ellison, Klein, Perlmutter, Donnelly, Foster, Speier; Bachus, LaTourette, Manzullo, Biggert, Garrett, Barrett, Neugebauer, Price, McCotter, and McCarthy of California.

Also present: Representative Baird.

The CHAIRMAN. The hearing will come to order.

I want to express my appreciation to Members on both sides for joining us today. There is a great deal of interest in the country on what we plan to do next year. The purpose of this is to focus on where we go from here.

We have two panels. The first panel consists of experts, many of whom have had responsibilities in the past but who do not now have governmental authority. That was a deliberate decision on my part so that we did not have to get clearances from various entities but could get the best thinking from thoughtful and experienced people. The second panel will consist of representatives of the financial institutions themselves.

I have spoken with the Minority, and we have agreed to 15 minutes on each side for opening statements to accommodate the members.

With that, we will begin with the chairman of the Subcommittee on Capital Markets, the gentleman from Pennsylvania, Mr. Kanjorski.

Mr. KANJORSKI. Mr. Chairman, we have reached a crossroads. Because our current regulatory regime has failed, we now must design a robust, effective supervisory system for the future. In devising this plan, we each must accept that regulation is needed to prevent systemic collapse. Deregulation, along with the twin notions that markets solve everything while government solves nothing, should be viewed as ideological relics of a bygone era.

We also need regulation to rein in the private sector's excesses. In this regard, I must rebuke the greed of some AIG executives and agents who spent freely at California spas and on English hunting trips after the company secured a $123 billion taxpayer loan. Their behavior is shocking. The Federal Reserve must police AIG spending and impose executive pay limits. If it does not, I will do so legislatively. After all, the Federal Reserve's lending money to AIG is no different from the Treasury's investing capital in a bank.

Returning to our hearing's main topic, I currently believe that the oversight system of the future must adhere to seven principles:

First, regulators must have the resources and flexibility needed to respond to a rapidly evolving global economy full of complexity and innovation.

Second, we must recognize the interconnectedness of our global economy when revamping our regulatory system. We must assure that the failure of one company, of one regulator or of one supervisory system does not produce disastrous, ricocheting effects elsewhere.

Third, we need genuine transparency in the new regulatory regime. As products, participants, and markets become more complex, we need greater clarity. In this regard, hedge funds and private equity firms must disclose more about their activities. The markets for credit default swaps and for other derivatives must also operate more openly and under regulation.

Fourth, we must maintain present firewalls, eliminate current loopholes, and prevent regulatory arbitrage in the new regulatory system. Banking and commerce must continue to remain separate. Financial institutions can neither choose their holding companies' regulators nor evade better regulation with a weaker charter. All financial institutions must also properly manage their risks, rather than shift items off balance sheet to circumvent capital rules.

Fifth, we need to consolidate regulation in fewer agencies but maximize the number of cops on the beat to make sure that market participants follow the rules. We must additionally ensure that these agencies cooperate with one another, rather than to engage in turf battles.

Sixth, we need to prioritize consumer and investor protection. We must safeguard the savings, homes, rights, and the financial security of average Americans. When done right, strong consumer protection can result in better regulation and more effective markets.

Seventh, in focusing financial firms to behave responsibly, we must still foster an entrepreneurial spirit. This innovation goal requires a delicate but achievable balancing act.

In sum, we have a challenging task ahead of us. Today's esteemed witnesses will help us to refine our seven regulatory principles and ultimately construct an effective regulatory foundation for the future. I look forward to their thoughts and to this important debate.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Cleveland—from Ohio—is now recognized for 2 minutes. I do not want to get too picky here.

Mr. LATOURETTE. Thank you very much, Mr. Chairman. Thank you for having this hearing. I am just a little east of Cleveland, thankfully. If I were from Cleveland, I would not be successful.

The witnesses' statements today have a lot of references to things like socialism, Ms. Rivlin's testimony in particular. I think that word "socialism" is being bandied about quite a bit today. The notion that right before we left we handed over $700 billion to the Secretary of the Treasury was disconcerting to a lot of us. Some of us voted “no,” not once but twice, on that piece of legislation.

I think the witnesses also talk about finger pointing as being not very productive, and I agree with that. I think that this hearing needs to look forward rather than back, but I think in order to look forward you do need to look back just a tad in that there are a lot of theories as to how we find ourselves in this situation.

Some are indicating that the 1999 legislation, Gramm-Leach-Bliley, is somehow in default. If that is the case, I would hope our witnesses would chat with us about the changes that need to be made to that to prevent this from happening again.

Many have indicated that the failure to put a tougher regulator instead of OHFEO over Fannie Mae and Freddie Mac saw the release of up to $1 trillion in subprime mortgages by those GSEs between 2005 and 2007. I think we should see if that is the problem.

Credit swaps apparently have no regulators. I wish they would talk a little bit about that.

Then, lastly, I did read the Washington Post editorial this morning that talks about mark-to-markets not being a problem. That does run counter to some of the things that people back in northeastern Ohio are indicating to me. I would wish that the witnesses would talk about that as well.

Just two quick unanimous consent requests: There is an article appearing in today’s Cleveland Plain Dealer that talks about an area called Slavic Village. I would ask unanimous consent that it be included in the record.

On October the 19th, Sunday, there was an article in the New York Times called, “Building Flawed American Dreams.” I would also ask unanimous consent that it be included in the record as well.

I yield back.

The CHAIRMAN. Without objection, it is so ordered.

I would ask unanimous consent that we give general leave for all members to insert into the record any material they wish.

Is there any objection? Hearing none, general leave is now granted, and members may insert whatever they wish into the record. They can, of course, allude to it as well if they would like to.

I will now yield 1 minute to the gentleman from New York, Mr. Ackerman.

Mr. ACKERMAN. A major contributing factor to the economic crisis facing the country is that our financial regulatory system is broken and needs to be fixed.

Without question, at least part of the blame for the seizure of our credit markets rests with the credit rating agencies. The credit ratings that were assigned to many mortgage-backed securities over the past 3 years were not based on sound historical data and for good reason. There was none. The types of securities that were bought and sold in the secondary market contain new subprime mortgage products that had no historical data on which to base any rating. Accordingly, the AAA ratings assigned to securities that contained subprime loans had absolutely no statistical basis whatsoever, but the pension fund managers and investors who placed their trust in the ratings took the credit rating agencies at their word and purchased these exotic products. That the credit rating agencies would rate these securities without any statistical data is bad enough, but continuing to do so is absolutely bewildering.

Mr. Chairman, if we are to fix the cause of this crisis, that area surely needs to be addressed. Mr. Castle and I have introduced legislation that would require nationally rated statistical rating organizations, those who are registered with the SEC, to assign two classes of ratings. One class, SRO ratings, would be reserved solely for homogenous securities whose ratings are based on historical statistical data and whose ratings pension fund managers and risk adverse investors could rely on. The other class of ratings would permit the rating agencies to continue to rate heterogeneous riskier products that may not have data.

The CHAIRMAN. The gentleman's time is expiring.

Mr. ACKERMAN. I would place the rest of my statement in the record.

The CHAIRMAN. Thank you.

We do have a large turnout. Members have asked for 1 minute, and we are going to have to ask that they stay very close to that.

Next, the gentleman from Texas, Mr. Neugebauer, for 2 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

One thing we know about Congress is that we do not necessarily do our best work in a crisis environment. We get a lot of pressure to just do something and to do something quickly. As a result, Congress can tend to overreact.

Our financial markets are not functioning normally, and our Federal Government has gone to some unprecedented steps to intervene in these markets. Certainly, we need to consider some regulatory improvements. This committee started regulatory hearings this year, and the industry and the Treasury and others have put forward regulatory proposals. Before Congress rushes to overhaul regulations, we need to do a complete autopsy of the current problems so that we know exactly what went wrong and what changes could help prevent this from happening again.

We also need to understand the outcomes of these problems on the structure of our financial services sector. Much focus has been on institutions that are too big or too interconnected to fail, but now it seems that more institutions fall into these categories. Expanding regulation to new entities also brings expectations of future government help.

Now, this debate isn't simply about having more regulation or about having less regulation; it is about having effective regulation. Effective regulation allows market discipline to drive decision-making, and it minimizes moral hazard. Effective regulation keeps the U.S. capital markets competitive with others around the world. Effective regulation protects investors and consumers and rewards innovation and responsible risk-taking.

We must also look at how the Federal Government plans to work its way out of these interventions. While some of these interventions are still being implemented, at some point the Federal Government will need to pull back. We need a bona fide exit strategy. This strategy needs to be a part of our discussion as we talk about regulatory changes. Moving forward, we need to work together across this committee aisle to come up with the right solution so we can leave America's financial system and economy stronger.

The CHAIRMAN. The gentleman from Massachusetts, Mr. Lynch, is recognized for 1 minute.

Mr. LYNCH. Thank you, Mr. Chairman.

I want to thank the ranking member as well and the witnesses for helping the committee with its work.

I want to associate myself with the remarks of the gentleman from Ohio, who said that the time for finger pointing is long past, and we really, within this committee structure, have to figure out where we need to go in the future and how to fix this regulatory system.

I would like the economists and the industry participants who are before us today to really focus on the purpose of the regulatory regime that we put in place, which is to provide information to investors, not only in external transparency but also in internal transparency. Because what we have seen is that these companies themselves do not understand truly the value of some of these complex derivatives that they hold.

So, again, I thank you for your attendance here today, but I would like to see the focus on transparency, after reading your remarks, and on the value that that would have in any system that we will devise going forward.

Thank you. I yield back.

The CHAIRMAN. The gentleman from Illinois, Mr. Manzullo, is recognized for 2 minutes.

Mr. MANZULLO. Thank you, Mr. Chairman, for holding this hearing today.

This committee needs to examine ways to ameliorate the impact of this crisis while examining long-term solutions to ensure that a crisis of this magnitude never happens again.

As we examine the underlying causes of this crisis, it is clear to me that Fannie Mae and Freddie Mac were right in the thick of things. Some of us in Congress have been fighting the unethical, illegal, and outright stupid underwriting practices at Fannie and Freddie for many years. Our efforts are a matter of public record, at least in the last 8 years, of going so far as to publicly confront Franklin Raines, who took $90 million in 6 years from Fannie Mae, and with regard to his fraudulent, unethical lobbying campaign in 2000 and in regard to the use of unethical accounting practices to inflate the bonuses of Fannie Mae's executives in 2004. In 2005, we finally got a bill to the Floor, a vote in favor of GSE reform, including the tough Royce amendment, to make even more difficult the types of practices to continue that we see have led to this crisis.

Any solution to this crisis undoubtedly needs to include a serious reexamination of the role that these GSEs will play in any future housing market. It is obvious that new regulations are necessary both to ease this crisis and to ensure that it never happens again. One thing for sure is that these two organizations need to be dissected, ripped apart, and examined thoroughly. Because once we find out what happened there as the root cause of the problem, we will make sure it never occurs again.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Georgia, Mr. Scott, is recognized for 1 minute.

Mr. SCOTT. Thank you, Mr. Chairman. Thank you for the hearing.

I think we have to realize that the damage has been done. We have to change our mindset from one of continuing to try to find blame; and, instead, we have to work on real solutions.

The number one issue we have before us is that our system is vulnerable. It has been vulnerable because a small quantity of high-risk assets undermined the confidence of investors as well as other market participants across a much broader range; and the combined effect of these factors, without the necessary regulation, caused the system to be vulnerable to self-reinforcing asset price and credit cycles.

The issue before us: What are the reforms that will be necessary to reduce the vulnerabilities in our economic system in the future? We have to press hard to make sure that we stop the blame game and understand that the American people are looking to us to provide real solutions.

Thank you, Mr. Chairman.

The CHAIRMAN. Mrs. Biggert of Illinois is recognized for 2 minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman. Thank you for holding this hearing to overhaul our financial services regulatory system and to bring it into the 21st Century.

During previous Congresses, this committee held about 100 hearings on GSE reform and led the House to pass a reform bill to rein in Fannie Mae and Freddie Mac. I worked on it and supported it in 2005 and 2007 because we saw the handwriting on the wall. These mortgage giants were too big, their accounting was irregular, and capital was too low.

We also produced legislation to reform the credit rating agencies, which we worked on, and that was signed into law in 2006. The SEC was unacceptably slow in implementing any reform.

Now more work needs to be done to ensure that agencies adequately evaluate credit risk. So our work to reform these regulations and many other reforms is by no means done nor will it ever be as the financial services industry is ever-evolving.

Today's witnesses will touch on a litany of concerns that merit further review and serious consideration by this committee. I think that our ultimate goals should be to bolster integrity and confidence in the U.S. financial system, to invigorate U.S. competition, to enhance consumer protections, to arm consumers with financial education and information, and to never again have the taxpayers pay for Wall Street's mistakes.

With that, I thank the witnesses for joining us today, and I look forward to hearing all of their ideas.

I yield back.

The CHAIRMAN. The gentleman from Missouri, Mr. Cleaver, is recognized for 1 minute.

Mr. CLEAVER. Mr. Chairman, I will reserve my comments for the question-and-answer period. Thank you.

The CHAIRMAN. Well, then, we will go to the gentleman from Florida, Mr. Klein. I apologize. We will go next to the gentleman from Texas, Mr. Green. I was out of order here.

Mr. GREEN. Thank you, Mr. Chairman. I will be brief.

Mr. Chairman, I thank you for hosting this hearing, because the American people are angry. They are upset. They understand that and believe that we have within our power to change things to make a difference. They are upset about golden parachutes as companies crash. They are upset because people were allowed to have loans that they could not afford. They are upset because there are markets that are unregulated. They expect us to act. I think this is the genesis of the action that we have to take.

I yield back.

The CHAIRMAN. The gentleman from New Jersey, Mr. Garrett, for 2 minutes.

Mr. GARRETT. I thank the chairman and the ranking member, and I thank also the members of the panel for your testimony we are about to hear.

As you all know, we are facing very challenging times in our Nation's financial services industry. It is important that we work in a bipartisan fashion to move forward to ensure that we put in place the proper regulatory framework to allow our economy to grow once again. But it has been said already: Before we are able to go forward with new and important changes to the overall regulatory structure for our financial services industry, I do believe that it is essential that we better understand just how we got into this problem.

One of the main parts of the problem was poor regulation in the past, specifically in the area of Fannie and Freddie. Now in the past, I know that our distinguished chairman has noted that he and his party were the ones to finally get a new GSE regulator over the finish line, albeit a little bit too late. That is quite true. However, there is a distortion of the facts to allow them to claim the mantle of being a champion of reform with Fannie and Freddie.

If you look back to the facts during the first committee markup of GSE regulation in 2005, it was I and some of my colleagues who have already spoken who offered a number of amendments to strengthen the regulatory controls and to reduce the overall risk that both companies posed to our Nation's economy. Each and every time, the chairman and everyone on the Democrat side of the aisle voted against these proposals, whether it was an amendment to raise the capital levels, to reduce the retained portfolios, to lower the conforming loan limits, or anything else. The other side of the aisle voted time and time again for what? Less regulation over these two companies. It was this lack of regulation that played a large part in getting us to where we are today.

So I honestly think that we need to learn the lessons of the past if we are going to be successful in the future. To formulate a new regulatory scheme is a process that is going to take a lot of months, a lot of conversations, many hearings, and as much input from all parties as possible to ensure that we create really a solid system under which we can safely move forward. Creating these new regulation reforms is not a partisan project. It is really about making sure American families are protected in the future from the kind of financial crisis that we are experiencing now.

Again, I thank the panel.

The CHAIRMAN. The gentleman from Florida, Mr. Klein.

Mr. KLEIN. Thank you, Mr. Chairman. I thank the ranking member as well for calling this hearing.

We all understand that this financial crisis is deep. It is affecting people with their investments. It is affecting small businesses' access to capital. I think many people understand that it is due, in part, to a lack of regulation and oversight.

Regulation does not have to be a burden. Smarter regulation will make our economy stronger, and I would definitely concur that we have to bring in, as we are doing today, some of the best and brightest people from all over our country to come up with some new ideas to have better regulation that will be effective in continuing to promote good ideas in the market and that will protect consumers and taxpayers.

A couple of suggestions:

One, when we talk about regulation, we have the SEC. We have the CFTC. There are ideas out there about a new financial product safety commission. It does not matter what we call it. I think the goals have to be the same, and that is to make sure that we are doing things to stimulate creative ideas. Again, the proper balance has to be in place.

Also, I have great concern about the credit rating agencies. It seems to me that there is an inherent conflict of interest there. The way it is set up right now, huge fees are being paid. And how things could be rated AA and AAA, when people are looking at these investments, there is a problem there.

Also, in encouraging competition among financial institutions, we have pretty much eliminated much of our antitrust law in the United States, and now we have more and more power consolidated with a few institutions in many different areas. This notion of "too big to fail" really bothers me. It is like continuing to build and build and build and being successful. When you make a number of bad decisions, I think you run out of that.

So I think it is a question of we need to go back and look at all of these. Do it in a bipartisan way, but let's move. Where there is a will, there is a way. Let's get it done as quickly and as reasonably possible.

The CHAIRMAN. The gentleman from Georgia is recognized for 2 minutes.

Mr. PRICE. Thank you, Mr. Chairman.

I want to join with some on both sides of the aisle who have said that the same old politics, frankly, from both sides will not get us to a solution to our current challenges.

There has been lots of excellent work done on attempting to identify the cause of our current financial challenge. I will be inserting a number of items into the record. One of them is an article entitled, "Another Deregulation Myth: A Cautionary Tale about Financial Rules that Failed."

While the genesis of our current challenge is certainly multifactorial, what began on a microlevel with imprudent borrowers and irresponsible lenders became a full-scale financial crisis, fueled by the GSEs that were rapidly expanding their purchasing and securitization of subprime mortgages.

Today, the resulting credit crunch is extended to every area of our economic system. What is taking place, though, is truly unprecedented: The direct Federal intervention in individual mortgages; a broad overreach by the Federal Reserve; an unlimited use of taxpayer dollars; and steps to nationalize banks. These actions are in their totality, I fear, an assault on American principles and on capitalism itself. It is a marked turn toward a nefarious ideal that problems can be solved by centralized decisionmaking here in Washington.

To have a full understanding of the financial services' regulatory state, there must be an investigation of all facets of the sector. I look forward to working with the chairman for a more broad appreciation of that in our hearing process.

Moving ahead, Congress must be sensible. The goals should be to eliminate previous destructive regulatory actions, not to eliminate all regulation but to have appropriate regulation, close the gaps in the regulatory framework, increase transparency, and enhance market integrity and innovation. The end result must promote economic growth and not stifle opportunity. I look forward to working with all who are of the same mind.

Thank you.

The CHAIRMAN. I will now recognize myself for our remaining time.

The purpose of this hearing was to be forward-looking, and that is why the panel of witnesses, proposed by both sides, are people who, in their testimony—and I was pleased to see it—talked about going forward. The next panel is a panel of people from the financial industry, and I had hoped we could focus on that, but after the gentleman from New Jersey's comments in having decried partisanship, he then practiced it. It does seem to me to be important to set the record clearly before us.

He alluded to a markup in 2005 in which the Democrats refused to support his amendments. The Democrats were, of course, in the Minority on the committee at that time. Had a Republican Majority been in favor of passing that bill, they would have done it.

The facts are—and, again, the gentleman from New Jersey continues to return to this, so we have to lay the record out here—that from 1995 to 2006, the Republicans controlled the Congress, particularly the House. Now, he has claimed that it was we Democrats—myself included—who blocked things. The number of occasions on which either Newt Gingrich or Tom DeLay consulted me about the specifics of legislation are far fewer than the gentleman from New Jersey seems to think. In fact, the Republican Party was in control from 1997 to 2005, and it did not do anything.

I now quote from the article that came out from the lead representative for FM Watch, which is the organization formed solely to restrain Fannie Mae and Freddie Mac and which is an organization, by the way, after the Congress finally passed the bill that came out of this committee in March of 2007, when Congress finally overcame some Republican filibusters that passed in 2008, that disbanded, saying that our bill had accomplished everything they had wanted.

He says he was asked if any Democrats had been helpful. Well, Barney Frank of Massachusetts: "The Senate Banking Committee produced a very good bill in 2004. It was S.190, and it never got to the Senate floor." The Senate was then, of course, controlled by the Republicans. "Then the House introduced a bill which passed," the one the gentleman from New Jersey alluded to, "but we could not get a bill to the floor of the Senate."

So here you have the documentation of the Republicans' failure to pass the bill.

He goes on to say, "After the 2006 election, when everyone thought FM policy focus issues would be tough sledding in their restrictions with Democrats in the majority, Barney Frank, as the new chairman, stepped up and said, 'I am convinced we need to do something.' He sat down with Treasury Secretary Paulson, and upset people in the Senate and Republicans in the House, but they came up with a bill that was excellent, and it was a bill that largely became law."

So there is the history. I will acknowledge that, during the 12 years of Republican rule, I was unable to get that bill passed. I was unable to stop them from impeaching Bill Clinton. I was unable to stop them from interfering in Terri Schiavo's husband's affairs. I was unable to stop their irresponsible tax cuts with the war in Iraq and in the PATRIOT Act that did not include civil liberties.

Along with the chairman of the committee, Mike Oxley, I was for a reasonable bill in 2005. Mr. Oxley told the Financial Times, of course, that he was pushing for that bill, the bill that's mentioned favorably by the advocate for FM Watch but that, unfortunately, all he could get from the Bush Administration was a "one-finger salute," and that killed the bill. Now, I regret that we have to get into this. I do hope we will look forward.

One other factor: There is a book out by Mark Zandi called, "Financial Shock." Mr. Zandi is an adviser to John McCain. Here's what he says on page 151:

"President Bush readily took up the homeownership at the time of the start of his administration. To reinforce this effort, the Bush administration put substantial pressure on Fannie Mae and Freddie Mac to increase their funding of mortgage loans to lower income groups. They had been shown to have problems during the corporate accountingscandals and were willing to go along with any request from the administration."

This is Mr. Zandi, John McCain's economic adviser.

"OHFEO, the Bush-controlled operation, set aggressive goals for the two giant institutions, which they met, in part, by purchasing subprime mortgage securities. By the time of the subprime financial shock, both had become sizable buyers."

That is John McCain's economic adviser. That is the advocate for FM Watch.

I will throw in one other factor, which notes, "The Congress in 1994," the last year of Democratic control, "passed the Homeowners' Equity Protection Act, giving the Federal Reserve the authority to regulate subprime mortgage. Mr. Greenspan refused to use it." As Mr. Zandi—again, John McCain's economic adviser—notes: "Democrats in Congress were worried about increasing evidence of predatory lending, pushed for legislation, pushed the Fed. We were rejected.”

I hope we can now go forward and try to deal with this situation. Yes, it is too bad that we did not do anything about subprime lending. I wish the bill that the Congress passed on Fannie and Freddie in 2007 and in this committee in 2008 had been passed earlier, and I wish I could eat more and not gain weight. Now let us get constructive about what we need to do in the future.

The gentleman from Alabama is recognized for the final 3 minutes.

Mr. BACHUS. Thank you, Mr. Chairman.

Mr. Chairman, I have a real concern, and that concern is that we are going to repeat the mistakes of the past. Now, how did we get here? We did it by the overextension of credit. We did it by overleveraging. We did it by too much borrowing and by too much lending. Yet what are we talking about this week and last month? We are talking about how can we stimulate lending, about how can we stimulate consumption, about how can we stimulate spending.

I believe that what we ought to be talking about is how we encourage people to save. How do we encourage people to live within their means? How do we encourage the government, not just American families but the government, to live within its means?

Another concern—and I think it is wrapped up in this—is this propensity of Americans to borrow more than they can afford to repay and to spend excessively and to not live within their means and to intervene on behalf of those who do. You know, we have talked about the market. Well, the market has been brutally efficient in the past several months. If it is allowed to work—and there will be negative consequences for all of us, but it will penalize those who took excessive risk. It will penalize those who borrowed more than they could afford. It has penalized our investment banks. There are no more investment banks. They have overleveraged.

The best way to discourage people from making bad loans is to let the market make them eat those losses. We need, I think, number one, to realize there are limits on what government can do to try to intervene in this market process.

Over a year ago, I was interviewed by the New York Times, by one of their editorial boards. I said this is not going to be pretty. It is going to be painful, but to a certain extent—and it is not popular to say—it is cathartic. It has a certain cleansing ability in the market by doing this. But we are going to be right back here in 5 years or in 10 years or in 15 years if we, as a country, go out and we have a stimulus package where we encourage people to spend money, we encourage them to take on loans, to take on debt, as opposed to figuring out a way to encourage them to balance their budgets as families and as a government.

If we are going to have an economic stimulus package, I have said it ought to be restricted to those things we have to do anyway, to those things we are going to do, like sewer projects and water projects, even tax policies, which encourage spending. We are here today because we borrowed excessively and because we did not live within our means.

I have said this, and I will close with this: On this committee, Ron Paul in a debate said we are not a wealthy nation. We are a nation of debtors. We are in debt. When we are in debt, and if we take on more debt, we are actually going to restrict our ability to grow and to thrive economically. That is a negative. Lending excessively and borrowing excessively is not something we ought to encourage. We are going to probably inflate this economy. We are going to probably print a lot of money, and we are going to, in my mind, it appears that we are going to continue to go down a road that has brought us here today. And that is not living responsibly.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

We will now begin with—the gentleman from Pennsylvania had a unanimous consent request he wanted to mention.

Mr. KANJORSKI. Mr. Chairman, I would ask unanimous consent to insert in the record at this point a communication from NAFCU regarding this hearing and the responsibility of the committee and other positions in the Congress and, also, a statement for the record from NASCUS of the State regulatory organization for credit unions on the same subject.

The CHAIRMAN. I thank the gentleman.

I would just take a second to note that both of them quite correctly pointed out that credit unions bear absolutely no responsibility for the bad lending practices, and I think they are entitled to that recognition.

We will now begin with our witnesses. We will begin with Alice Rivlin, who is a senior fellow at the Metropolitan Policy Program, economic studies, and director at the Brookings Institution.

Dr. Rivlin.

STATEMENT OF THE HONORABLE ALICE M. RIVLIN, SENIOR FELLOW, METROPOLITAN POLICY PROGRAM, ECONOMIC STUDIES, AND DIRECTOR, GREATER WASHINGTON RESEARCH PROJECT, BROOKINGS INSTITUTION

Ms. RIVLIN. Thank you, Mr. Chairman, and members of the committee.

Past weeks have witnessed historic convulsions in financial markets around the world. The freezing of credit markets and the failure of major financial institutions triggered massive interventions by governments and by central banks as they attempted to contain the fallout and to prevent total collapse. We are still in damage control mode. We do not yet know whether these enormous efforts will be successful in averting a meltdown, but this committee is right to begin thinking through how to prevent future financial collapses and how to make markets work more effectively.

Now pundits and journalists have been asking apocalyptic questions: Is this the end of market capitalism? Are we headed down the road to socialism? Of course not. Market capitalism is far too powerful a tool for increasing human economic wellbeing to be given away because we used it carelessly. Besides, there is no viable alternative. Hardly anyone thinks we would be permanently better off if the government owned and operated financial institutions and decided how to allocate capital.

But market capitalism is a dangerous tool. Like a machine gun or a chain saw or a nuclear reactor, it has to be inspected frequently to see if it is working properly and used with caution according to carefully thought-out rules. The task of this committee is to reexamine the rules.

Getting financial market regulation right is a difficult and painstaking job. It is not a job for the lazy, the faint-hearted, or the ideologically rigid. Applicants for this job should check their slogans at the door. Too many attempts to rethink the regulation of financial markets in recent years have been derailed by ideologues shouting that regulation is always bad or, alternatively, that we just need more of it. This less versus more argument is not helpful. We do not need more or less regulation; we need smarter regulation.

Moreover, writing the rules for financial markets must be a continuous process of fine-tuning. In recent years, we have failed to modernize the rules as markets globalized, as trading speed accelerated, as volume escalated, and as increasingly complex financial products exploded on the scene. The authors of the financial market rule books have a lot of catching up to do, but they also have to recognize that they will never get it right or will be able to call it quits. Markets evolve rapidly, and smart market participants will always invent new ways to get around the rules.

It is tempting in mid-catastrophe to point fingers at a few malefactors or to identify a couple of weak links in a larger system and say those are the culprits and that if we punish them the rest of us will be off the hook, but the breakdown of financial markets had many causes of which malfeasance and even regulatory failure played a relatively small role.

Americans have been living beyond their means individually and collectively for a long time. We have been spending too much, have been saving too little, and have been borrowing without concern for the future from whomever would support our overconsumption habit—the mortgage company, the new credit card, the Chinese Government, whatever. We indulged ourselves in the collective delusion that housing prices would continue to rise. The collective delusion affected the judgment of buyers and sellers, of lenders and borrowers and of builders and developers. For a while, the collective delusion was a self-fulfilling prophesy. House prices kept rising, and all of the building and borrowing looked justifiable and profitable. Then, like all bubbles, it collapsed as housing prices leveled off and started down.

Now bubbles are an ancient phenomenon and will recur no matter what regulatory rules are put in place. A housing bubble has particularly disastrous consequences because housing is such a fundamental part of our everyday life with more pervasive consequences than a bubble in, say, dot com stocks.

More importantly, the explosion of securitization and increasingly complex derivatives had erected a huge new superstructure on top of the values of the underlying housing assets. Interrelations among those products, institutions, and markets were not well-understood even by the participants. But it is too easy to blame complexity, as in risk models failed in the face of new complexity. Actually, people failed to ask commonsense questions: What will happen to the value of these mortgage-backed securities when housing prices stop rising? They did not ask because they were profiting hugely from the collective delusion and did not want to hear the answers.

Nevertheless, the bubbles and the crash were exacerbated by clear regulatory lapses. Perverse incentives had crept into the system, and there were instances where regulated entities, even the Federal Reserve, were being asked to pursue conflicting objectives at the same time.

These failures present a formidable list of questions that the committee needs to think through before it rewrites the rule book. Here are my offers for that list:

We did have regulatory gaps. The most obvious regulatory gap is the easiest to fill. We failed to regulate new types of mortgages—not just subprime but Alt-A and no doc and all the rest of it—and the lax, sometimes predatory lending standards that went with them. Giving people with less than sterling credit access to homeownership at higher interest rates is actually, basically, a good idea, but it got out of control. Most of the excesses were not perpetrated by federally regulated banks, but the Federal authorities should have gotten on the case, as the chairman has pointed out, and should have imposed a set of minimum standards that applied to all mortgage lending. We could argue what those standards should be. They certainly should include minimum downpayments, the proof of ability to pay, and evidence that the borrower understands the terms of the loan. Personally, I would get rid of teaser rates, of penalties for prepayment and interest-only mortgages. We may not need a national mortgage lender regulator, but we need to be sure that all mortgage lenders have the same minimum standards and that these are enforced.

Another obvious gap is how to regulate derivatives. We can come back to that. But much of the crisis stemmed from complex derivatives, and we have a choice going forward. Do we regulate the leverage with which those products are traded or the products themselves?

The CHAIRMAN. Doctor, you will need to wind this up soon.

Ms. RIVLIN. Okay. Then, if you would prefer, I can submit the rest of the statement for the record.

The CHAIRMAN. It will be in the record, and we will have plenty of time for questions.

[The prepared statement of Ms. Rivlin can be found on page 123 of the appendix.]

The CHAIRMAN. In fairness to the members who have made a special trip, what I am going to do is, as we do the questioning, when we finish the questioning on our side of the first panel and when we have the second panel, I will begin the questioning with where we left off in the first panel so that every member will get a chance to question at least one set of witnesses before any member questions again. I will defer my own questioning, because I do appreciate members coming. So we will have the questioning in regular order for the first panel, and then we will pick up where we left off at that first panel for the second panel.

Secondly, we do not have any government officials here today, which means that the front row, which is usually reserved for their entourages, is available. So if people would like to sit in those seats, please feel free. There are people standing up. I do not think we will have any deputy assistant, executive whatever whispering in anybody's ear today, so the rest of you should feel free to sit there, and you can look bureaucratic if you think you will fit in better.

Dr. Stiglitz.

STATEMENT OF JOSEPH E. STIGLITZ, PROFESSOR, COLUMBIA UNIVERSITY

Mr. STIGLITZ. Mr. Chairman and members of the committee, first let me thank you for holding these hearings. The subject could not have been 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. There is virtual unanimity that part of the reason that it has performed so poorly is due to inadequate regulations and due to inadequate regulatory structures.

I want to associate my views with Dr. Rivlin's in that it is not just a question of too much or too little; it is the right regulatory design.

Some have argued that we should wait to address these problems. We have a boat with holes, and we must fix those holes now. Later, there will be time to address these longer-run regulatory problems. We know the boat has a faulty steering mechanism and is being steered by captains who do not know how 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 rocky shoals before reaching port. The time to fix the regulatory problems is, thus, now.

Everybody agrees that part of the problem is a lack of confidence in our financial system, but 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 moneys to their shareholders.

This morning, I want to describe briefly the principal objectives and instruments of a 21st Century regulatory structure. Before doing so, I want to make two other prefatory remarks.

The first is that the reform of financial regulation must begin with the 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?

The second remark is to renew the call to do something about the homeowners who are losing their homes and about our economy which is going deeper into recession. We cannot rely on trickle-down economics—throwing even trillions of dollars at financial markets is not enough to save our economy. We need a package simply to stop these things from getting worse and a package to begin the recovery. We are giving a massive blood transfusion to a patient who is hemorrhaging from internal bleeding, but we are doing almost nothing to stop that internal bleeding.

Let me begin with some general principles. It is hard to have a well-functioning, 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, to allocate capital, and to manage risk, transferring it from those less able to bear it to those more able. Our financial system encourages spendthrift patterns, leading to near zero savings. They have misallocated capital; and instead of managing risk, they have created it, leaving huge risks with ordinary Americans who are now bearing the huge costs because of these failures.

These problems have occurred repeatedly and are pervasive. This is only the latest and the biggest of the bailouts that have become a regular feature of our peculiar kind of capitalism. The problems are systemic and systematic. These systems, in turn, are related to three more fundamental problems.

The first is incentives. Markets only work well when private rewards are aligned with social returns, but, as we have seen, that has not been the case. The problem is not only with incentive structures and it is not just the level, but it is also the form, which is designed to encourage excessive risk-taking and to have short-sighted behavior.

Transparency. The success of a market economy requires not just good incentive systems but good information. Markets fail to produce sufficient outcomes when information is imperfect or asymmetric. Problems of lack of transparency are pervasive in financial markets. Nontransparency is a key part of the credit crisis that we have experienced in recent weeks. Those in financial markets have resisted improvements such as more transparent disclosure of the cost of stock options, which provide incentives for bad accounting. They put liabilities off balance sheets, making it difficult to assess accurately their net worth.

There is a third element of well-functioning markets—competition. There are a number of institutions that are so large that they are too big to fail. They are provided an incentive to engage in excessively risky practices. It was a "heads I win," where they walk off with the profits, and a "tails you lose," where we, the taxpayers, assume the losses.

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 during the past quarter century has no grounding in economic theory nor historical experience. Quite the contrary, modern economic theory explains why the government must take an active role, especially in regulating financial markets. Regulations are required to ensure the safety and soundness of individual financial institutions and of the financial system as a whole to protect consumers, to maintain competition, to ensure access to finance for all, and to maintain overall economic stability.

In my remarks, I want to focus on the outlines of the regulatory structure, focusing on the safety and the soundness of our institutions and on the systematic stability of our system. In thinking about a new regulatory structure for the 21st Century, we need to begin by observing that there are important distinctions between financial institutions that are central to the functioning of the economic system whose failures would jeopardize the economy, those who are entrusted with the care of ordinary citizens' money, and those who prove investment services to the very wealthy.

The former include commercial banks and pension funds. These institutions must be heavily regulated in order to protect our economic system and to protect the individuals whose money they are supposed to be taking care of. There needs to be strong ring-fencing of these core financial institutions. We have seen the danger of allowing them to trade with risky, unregulated parties, but we have even forgotten basic principles. Those who managed 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 with the more risky activities of investment banks aimed at upper income Americans. The repeal of Glass-Steagall not only ushered in a new era of conflicts of interest but also a new culture of risk-taking in what are supposed to be conservatively managed financial institutions.

We need more transparency. A retreat from mark-to-market would be a serious mistake. We need to ensure that incentive structures do not encourage excessively risky, shortsighted behavior, and we need to reduce the scope of conflicts of interest, including at the rating agencies, conflicts of interest which our financial markets are rife with.

Securitization for all of the virtues in diversification has introduced new asymmetries of information. We need to deal with the consequences.

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 product safety commission and unless their uses conform to the guidelines established by that commission.

Regulators should encourage the move to standardized products. We need countercyclical capital adequacy and provisionary requirements and speed limits. We need to proscribe excessively risky and exploitive lending practices, including predatory lending. Many of our problems are a result of lending that was both exploitive and risky. As I have said, we need a financial product safety commission, and we need a financial system stability commission to assess the overall stability of the system.

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. The regulatory system needs to be comprehensive. Otherwise, funds will flow through the least regulated part.

Transparency requirements in 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.

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. Incentives also play a role in failed enforcement and help explain why self-regulation does not work. Those in financial markets had incentives to believe in their models. They seemed to be doing very well. That is why it is 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 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 make it clear why self-regulation will not work or at least will not suffice.

Mr. KANJORSKI. [presiding] Doctor, please wrap up.

Mr. STIGLITZ. I noted that there has to be an alignment of private rewards and social returns. I think it is imperative that we make those who have contributed to the problem, the financial sector, now pay for the cleanup.

Financial behavior is also affected by many other parts of our tax and legal structures. Financial market reform cannot be fully separated from reform in these other laws. For instance, our tax laws, particularly the preferential treatment of capital gains—

The CHAIRMAN. Joe, he's nicer than me, so you have to stop it.

Mr. STIGLITZ. Okay. Let me just say that there is also an international dimension, that we can redesign our financial system to actually encourage innovation. We have had bad innovation. The agenda for regulatory reform is large. It will not be completed overnight. But we will not begin to restore confidence in our financial system until and unless we begin serious reform.

Let me submit my whole statement for the record.

The CHAIRMAN. Yes, we are going to have a lot of questions. There will be elaboration and a chance to elaborate with questions.

[The prepared statement of Mr. Stiglitz can be found on page 149 of the appendix.]

The CHAIRMAN. Dr. Seligman.

STATEMENT OF JOEL SELIGMAN, PRESIDENT, UNIVERSITY OF ROCHESTER

Mr. SELIGMAN. Mr. Chairman, we have reached a moment of discontinuity in our Federal and State systems of financial regulation that will require a comprehensive reorganization. Not since the 1929–1933 period, has there been a period of such crisis and such need for a fundamentally new approach to financial regulation.

Now, this need is only based, in part, on the economic emergency. Quite aside from the current emergency, finance has fundamentally changed in recent decades while financial regulation has moved far more slowly.

First, 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.

Second, in the New Deal period, the challenge of regulation was essentially domestic. Increasingly, our fundamental challenge in financial regulation is international.

Third, in 1930, approximately 1.5 percent of the American people directly owned stock on the New York Stock Exchange. Today, a substantial majority of Americans own stock directly or indirectly through pension plans or mutual funds. A dramatic deterioration in stock prices affects the retirement plans and sometimes the livelihoods of millions of Americans.

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

Fifth, and 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.

Against this backdrop, what lessons does history suggest for the committee to consider as it begins to address the potential restructuring of our system of 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 which will operate best when far more evidence is available.

The creation of the Securities and Exchange Commission, for example, and the adoption of six Federal securities laws between 1933 and 1940 was preceded by the Stock Exchange Practices hearings of the Senate Banking Committee and counterpart hearings in the House between 1932 and 1934. Second, I would strongly urge each House of Congress to create a select committee similar to that employed after September 11th to provide a focused and less contentious review of what should be done. The most difficult issues in discussing appropriate reform of our regulatory system become far more difficult when multiple congressional committees with conflicting jurisdictions address overlapping concerns.

Third, 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 it also means, for example, our historic system of State insurance regulation should be reexamined. 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. Fourth, a particularly difficult issue to address will be the appropriate balance between the need for a single agency to address systemic risk and the advantages of expert specialized agencies. There is today an obvious and cogent case for the Federal Reserve System and the Department of the Treasury to serve as a crisis manager to address issues of systemic risk, including those related to firm capital and liquidity. But to create a single clear crisis manager only begins analysis of what appropriate structure for Federal regulation should be. Subsequently, there must be considerable thought as to how best to harmonize the risk management powers with the role of specialized financial regulatory agencies that continue to exist.

Existing financial regulatory agencies, for example, often have dramatically different purposes and scopes. Bank regulation, for example, has long been focused on safety insolvency, securities regulation on investor protection.

Similarly, these differences and purposes in scope in turn are based on different patterns of investors, retail versus institutional for example, different degrees of internationalization and different risk of intermediation in specific financial industries. The political structure of our existing agencies is also strikingly different. The Department of the Treasury, of course, is part of the Executive Branch. The Federal Reserve System and the SEC, in contrast, are independent regulatory agencies. But, the SEC's independence itself as a practical reality is quite different from the Federal Reserve System with a form of self-funding than for the SEC and most independent regulatory agencies whose budgets are presented as part of the Administration's budget. Underlying any potential financial regulatory reorganization are pivotal questions I urge this committee to consider, such as what should be the fundamental purpose of new legislation, should Congress seek a system that effectively addresses systemic risk, safety insolvency, investor consumer protection, or other overarching objectives.

How should Congress address such topics as coordination of inspection examination, conduct or trading rules enforcement of private rules of action? Should new financial regulators be part of the Executive Branch or independent regulatory agencies? Should the emphasis in the new financial regulatory order be on command and control to best avoid economic emergency or on politicization to ensure that all relevant views are considered by financial regulators before decisions are made? How do we analyze the potentialities of new regulatory norms in the increasingly global economy? What role should self-regulatory organizations such as FINRA have in a new system of financial regulations? These and similar questions should inform the most consequential debate over financial regulation that we have experienced since the new deal period.

[The prepared statement of Mr. Seligman can be found on page 140 of the appendix.]

The CHAIRMAN. And finally, Manuel Johnson, Mr. Johnson.

STATEMENT OF THE HONORABLE MANUEL H. JOHNSON, JOHNSON SMICK INTERNATIONAL, INC.

Mr. JOHNSON. Thank you, Mr. Chairman. The current state of the U.S. financial regulatory system is a result of an extreme breakdown in confidence by the credit markets in this country and elsewhere so that U.S. regulatory authorities have determined it necessary to practically underwrite the entire process of credit provision to private borrowers. All significant U.S. financial institutions that provide credit have some form of access to Federal Reserve liquidity facilities at this time. All institutional borrowers through the commercial paper market are now supported by the Federal Reserve System.

Many of the major institutional players in the U.S. financial system have recently been partially or fully nationalized. While it appears that the Federal Reserve, along with other central banks, have successfully addressed the fear factor regarding access to liquidity, there are lingering fears in the markets about the economic viability of many financial firms due to the poor asset quality of their balance sheets. All of these measures to restore confidence are the result of huge structural and behavioral flaws in the U.S. financial system that led to excessive expansion in subprime mortgage lending and other credit related derivative products.

Because these structural problems have encouraged distorted behavior over a long period of time, it will take some time to completely restore confidence in these credit markets. However, over time, as failed financial institutions are resolved through private market mergers or asset acquisitions and government takeovers and restructurings, confidence in the U.S. credit system should be gradually restored. Unfortunately, this will likely be very costly to U.S. taxpayers. Over the longer term, the public, I think, should be very concerned about the implications of the legislative and regulatory efforts to deal with this crisis of confidence.

From my perspective, permanent government control over the credit allocation process is economically inefficient and potentially even more unstable. One of the major reasons why excesses developed in housing finance was a failure of Federal regulators to adequately supervise the behavior of bank holding companies. Specifically, the emergence of structured investment vehicles (SIVs), an off-balance sheet innovation by bank holding companies to avoid the capital requirements administered by the Federal Reserve, set in motion a virtual explosion of toxic mortgage financings.

While the overall structure of bank capital reserve requirements was sound relative to bank balance sheets, supervisors were simply oblivious to bank exposures off the balance sheet. If bank supervisors could not police the previous and much less pervasive regulatory structure, you can imagine the impossibility of policing a vastly more extensive and complicated structure. Again, while bank capital requirements are reasonably well-designed today, it is supervision that is a problem. The U.S. financial system has been the envy of the world. Its ability to innovate and disburse capital to create wealth in the United States and around the globe is unprecedented. A new book by my colleague, David Smick, entitled, "The World is Curved," documents the astonishing benefits the U.S. financial system has provided in the process of globalization. The book also clearly describes the dangers presented by regulatory and structural weaknesses today.

It would be a mistake to roll back the clock on the gains made in U.S. finance over the last several decades. As the current crisis of confidence subsides and stability is restored, U.S. regulators should develop clear transition plans to exit from direct investments in private financial institutions and attempt to roll back extended guarantees to credit markets beyond the U.S. banking system. Successfully supervising the entire U.S. credit allocation process is simply impossible without dramatically contracting the system. More resources and effort should be put into supervision of bank holding companies. Financial regulators should focus on the full transparency of securitization development and clearing systems. Accurate disclosure of risk is the key to effective and sound private sector credit allocation. Reforms following these type principles should help maintain U.S. prominence in global finance and enhance living standards both domestically and internationally. Thank you, Mr. Chairman.

[The prepared statement of Mr. Johnson can be found on page 121 of the appendix.]

The CHAIRMAN. Thank you.

We will begin the questioning with Mr. Kanjorski. I remind members on the Democratic side that if we have to cut this off we will begin—if we have to stop at some point to let these witnesses go, we will begin questioning with those members who did not get a chance to question in the first panel. So you might decide if you want to talk to them or the next group. It is your choice. The gentleman from Pennsylvania.

Mr. KANJORSKI. Thank you very much, Mr. Chairman. Gentlemen, there have been suggestions out there from various members of the panel that we create some sort of commission or select committee. And I assume that is so that we could get to the basis of what the cause of the present economic situation is and where there is a failure or a weakness in the existing system. I guess my question to you is, one, is this ever attainable or is it not only an economic problem but also a political problem? I notice of late and even occurring here today that there is a constant argument about who is at fault.

I have heard a lot of my colleagues question that it is truly a problem of the Clinton Administration. And then someone said no, it is really a problem of the Buchanan Administration. And going all the way back, I am not sure whose fault it is. Maybe it is the fault of George Washington; if we didn't have the country, we wouldn't have the problem. But before we can get to a clean-up situation, would you recommend that almost immediately we take steps to create either a commission empowered for 90 or 180 days to report back to the Congress to get some equilibrium as to cause so that we can then decide legislatively how to approach this? And particularly, before I turn it over to you all for answers, I was impressed in listening to you that if you remember just 3 years ago, the country was in the throes of almost a 50/50 argument that Social Security should be privatized.

And at that time, the argument was being made that, look, if we did that, how much greater that would be to the assistance of people having a better retirement. And I didn't hear a lot of people raise objections to the risk. It was like, great idea, let us do it. And I just keep thinking as I meet with my constituents today how, thank God, 3, 3½ years ago, this country didn't fall into that terrible trap or we would really have a disaster on our hands in terms of all of the Social Security funds that probably would have been lost by this time.

So what I am sort of asking you for is, if you can, give us an outline of how we would start this—a commission, a select committee, whether or not then we should go to the regular order of the Congress, how to act, and can we do it without establishing some basic foundation, if I may? Dr. Seligman.

Mr. SELIGMAN. I think there are two different fundamental needs. First, you need some mechanism for investigating the relevant facts. And a challenge you have is because so many of the financial regulators were involved in regulation which has been called somewhat into question, how to create an independent mechanism. In 1987, after the stock market crashed then there were a number of reports. Some came from Congress. There was a particularly good one in that case that came from the Department of the Treasury. But one of the first things you should do is see if through Congress or otherwise you want to stimulate some sort of special study on a timeline which will be able to present to you a comprehensive report on what has happened.

Second, and the point I stressed in my testimony, select committees, I think, are important for a different reason. Different congressional committees have different jurisdiction. To give you an illustration, this committee has a very broad ambit but it does not, for example, have within its scope the Commodities Futures Trading Commission, which reports to a separate committee. Given the urgency with which you should address financial futures and credit derivatives which have been not clearly allocated in our current regulatory scheme, a select committee would be a mechanism to a more comprehensive review. You could have everybody at the table hearing the same evidence and hopefully get to the appropriate resolution.

Mr. KANJORSKI. Very good. Dr. Stiglitz.

Mr. STIGLITZ. I agree that one needs to approach this comprehensively. I think that looking at the past and what has caused this problem is only part of what needs to be done, because there are all kinds of crises we could have had and that we will have in the future. We are looking at this in a way parochially as Americans. This has been a global crisis. Countries that didn't have our particular institutions have also had problems. And so I think we really need to think about this looking forward, taking into account the changes in the financial markets that have occurred, what are the risks, and how do we manage those risks. And I guess a final point, I think one of the real difficulties is the very large role of the special interest at play in shaping our current financial structures, regulatory structures, the failures of the current financial regulators are going to make it very difficult to go forward. That is something you just have to take into account, that they are going to try to shape the regulations to allow them to keep doing what they did in the past because it worked for them.

The CHAIRMAN. Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. Mr. Johnson, in your testimony you said regulators should develop a clear transition plan to exit from the direct government investments and credit backstops moving forward. And quite honestly, I agree that we need an exit strategy. One of the reasons that I voted against the plan, not once, but twice, was that nobody was really ever able to articulate a clear exit strategy of this major market intervention by the Federal Government. Can you elaborate a little bit more on when, in your estimation, it becomes appropriate to begin that transition where we begin to back the elephant out of the room, so to speak, and let these markets, you know, return to an environment where the government is not intervening?

Mr. JOHNSON. Yes, Congressman. Well, I agree with some of the other comments here that something like a select committee could be organized to look at this problem in a comprehensive way. I don't really have much input on the best organization to deal with this issue because there are many oversight organizations that have been set up over the years to cover almost all aspects of the regulatory sector. But I do strongly believe that once financial markets are stabilized and confidence is restored, we should have a transition plan and an exit strategy. A specific exit date is important even if that date is somewhat arbitrary.

I am not a believer in central government control over the entire credit allocation process. I am a believer in strong supervision and regulation over those aspects of the financial system that are underwritten by the U.S. taxpayer such as the banking sector. But what worries me now is we have spread the U.S. Federal safety net over the entire financial system, the entire credit allocation process today. And I think we must determine an exit from that. The risk reward structure is what drives this economy and we have failed miserably to supervise the safety net and keep it more narrowly focused.

We have allowed excessive risk-taking with no accountability and no transparency in the risk process. And therefore, today we are afraid to let anyone fail because we don't know what the systemic damage of this might be. Failure is a critical part of this system. Yes, there must be rewards for risk-taking. But if you can't fail when you make bad mistakes, the system is broken and you might as well just go to total control.

So I would say that once a comprehensive review has been undertaken, you should rationalize the regulatory structure, in my opinion, as narrowly as possible to limit the safety net. But, I wouldn't favor doing that unless people were accountable for their risk-taking. And so—but I would favor shrinking this back to the bank holding company structure and of course having as much disclosure and transparency as possible in the securitization process so that risk takers know what risks they are taking. And I can't say the exact moment at which that should be done, but it should be done when you have rationalized in a comprehensive way and feel strongly that you understand what has happened and that the supervisory structure is adequate. But I think the sooner the better that you can get on with that I would favor.

Mr. NEUGEBAUER. Well, you did a great job. I had two more questions for you and you answered both of those. And so I appreciate that. Just a lightning round here. One of the concerns I have is there has been a lot of talk about systemic risk. And I think, Mr. Stiglitz, you mentioned "too big to fail." Yet part of the plan here is that we are encouraging a massive consolidation of entities here, and are we, in fact, continuing to add to the systemic risk in the marketplace.

Mr. STIGLITZ. I actually remarked on that. I think it is a very serious problem, and I think part of a general failure to enforce antitrust laws in the last few years. And so one of the things I think is part of your exit strategy is that we have to think about breaking up some of the big banks and realizing that actually the economies of scale are not as big. And one of the things that I think has facilitated this growth has been the recognition that they are too big to fail and will put our money there because the government implicitly or explicitly is going to guarantee them.

The CHAIRMAN. Thank you.

Mr. SELIGMAN. Let me just make a quick—

The CHAIRMAN. Very quickly, Mr. Seligman.

Mr. SELIGMAN. There is another aspect of systemic risk, and that is counterparties. That is with derivative instruments. That is regardless of the size of the institution if it is linked to other institutions through transactions where the failure of one can set in a cascading effect. That is what the real risk with Lehman Brothers turned out to be.

The CHAIRMAN. I recognize the gentleman from New York and ask you to give me 15 seconds. It occurs to me that what we should be looking for as an offset to the doctrine of "too big to fail," we should have a rule of "too failing to be big," and that is the job of regulation. The gentlewoman from New York.

Mrs. MALONEY. Thank you, Mr. Chairman. I would like to welcome all the panelists and mention to Dr. Stiglitz that I have enjoyed your books, particularly the latest one, "The $3 Trillion War." And I would like to reference your written comments where you said that America's financial markets have engaged in anticompetitive practices, especially in the area of credit cards. And you go further on to say, and I quote, "the huge fees have helped absorb the losses from their bad lending practices, but the fact that the profits are so huge should be a signal that the market has not been working well." I do want to note that the Federal Reserve has also called credit practices and credit cards unfair deceptive and anticompetitive and this committee and this House passed in a bipartisan way reform legislation in this area, so we are acting in that area.

You also mentioned that one of the problems is the lack of transparency. I would like to hear your ideas on a master super counterparty netting system. The idea of the system would be to provide a complete and transparent view of the entire financial system which would require every dealer to download all transactions every night, including all international. This would be in one place, an international area that would have a transparency so that we could track what is happening in the system. We know that derivatives are a huge part of it. But to date, the credit derivatives have been what we have focused on, yet they are only 10 percent of the global derivatives volume, so we may have an even larger problem that we have no idea how wide it is, and with such a super counterparty netting system, add more transparency, and help us move forward towards a better knowledge about our markets.

Mr. STIGLITZ. I think that would help. One of the things I commented on in my remarks was the need for standardization of these products. Because one of the problems is that if they are very complex, it is hard to know what is being netted. And so part of what needs to be done is moving towards more standardization which would allow greater transparency in the products themselves and greater competition in the market. When you have highly differentiated products it is more likely that they will be less transparent and that markets will be less competitive.

Mrs. MALONEY. Thank you. What I am hearing from my constituents is they are not getting access to credit still, even though it was reported Monday that the credit markets are easing. And these are established businesses, small and large, that are paying their loans on time, yet some banks are pulling their loans. This could be a downward spiral forcing them into bankruptcy, hurting our economy. So I would like to ask Ms. Rivlin, would one approach to help the stability in the credit markets be that at the very least, we could guarantee the loaning between the banks and have a blanket guarantee of new short-term loans to one another by the central banks? Would that be helpful in this regard? We have seen, so far, a piecemeal approach, as has been mentioned by the panelists, and not only in America, but in Europe and Asia as well. This obviously requires a high degree of international cooperation. I welcome your remarks and other panelists on this idea. Would that ease the credit? Would that help us get the credit out to the substantial businesses that are employing paying taxes part of our economy?

Ms. RIVLIN. I am sorry, a guarantee of interbank lending? Well, that has been discussed. I think we may not need that. It does look as though interbank lending is coming back. And the international cooperation doing the same thing in different financial markets has been actually I think quite impressive that the central banks and treasuries have been working together. So I am not sure that we actually need at this point a guarantee of interbank lending. The interbank lending rates are coming down and the capital injection, it seems to me, is probably going to be enough to do that.

Mrs. MALONEY. Mr. Stiglitz.

Mr. STIGLITZ. I am not sure that the capital injection is going to be enough. But I do feel nervous about guaranteeing individual loans. I think guaranteeing interbank lending again would facilitate that market. But that itself, again, is not going to suffice. The real problem and the reason that we want to have a good financial system is that credit is the life blood of an economy. And when there is the degree of uncertainty going into an economic downturn, the fundamental problem, the hemorrhaging at the bottom, the foreclosures are going to continue because house prices are going to fall. If we aren't doing anything about either the stimulus, the stimulating economy, or about the foreclosure, banks are going to be more conservative. And so I think it was necessary to recapitalize the banks but it is not going to be sufficient to address our problems.

The CHAIRMAN. Mr. LaTourette.

Mr. LATOURETTE. Thank you, Mr. Chairman. Dr. Stiglitz, I want to thank you for your testimony. I want to thank everybody for your testimony. But Dr. Stiglitz, your testimony hit on all the points that I think I was attempting to make in my opening remarks. The first question I have for you is, I am over here, Dr. Stiglitz. I am one of the few guys with a beard in the room besides you. You made the observation during your truncated opening remarks that there was a feeling at least on your part and I think it is one that is shared by a lot of people that the people who made the mess should clean up the mess. And in my part of the world in Ohio, people believe that not only includes paying in dollars, but some people think people should go to prison. I agree with that if you have broken the rules and cost people their life savings. But I think I would ask you, what do you mean, and how would you envision that the people who have made the mess pay for the mess, clean up the mess?

Mr. STIGLITZ. In my more extended remarks, I gave the analogy that in environmental economics, we have a principle called "pollute or pay." And financial markets have polluted our economy with toxic mortgages and they need, ought to pay for the clean-up. The fact is that we are providing now capital to the financial sector taking advantage of the low cost of funds that the government has. And the criteria that we have set is that we just get paid back that low cost funds. I think that what I had in mind is that if it turns out that we don't make a good return on the money that we have put into the financial system, and I mean not a zero return, but above the zero because we bore a risk, that there be some form of taxation of the financial institutions that have made use of these funds. For instance, a tax on excessive capital gains imposed on these financial institutions.

Mr. LATOURETTE. I agree with you. I think that is why some of us weren't so crazy about the bailout of $700 billion, because it didn't have one that guaranteed. And it seemed that rather than finding different ways to take care of this, we just gave $700 billion to folks and said, we hope that these toxic assets have a market value some day in the future, which is a big "if" for a lot of money.

The other observation you made was about a transfusion, the $700 billion being a transfusion given to a hemorrhaging patient, I think were your words. And that—did it have to be just from your observation a publicly financed bailout? There was a proposal for instance for repatriation of offshore funds held by American corporations to buy these toxic assets who then obviously would receive something in the form of a capital gains treatment if they bought them, created a market for them, and held them. Do you think—I mean, a lot of people, we talk about greed, we talk about lack of regulation or poor regulation, we talk about people overborrowing, buying houses they had no business buying. But doesn't it offend your sensibility, I guess, that all this bailout has to come from the public sector at this moment in time?

Mr. STIGLITZ. It does offend my sensibilities, but I don't think there was any alternative. In earlier crises in 1997 and 1998, the global financial crisis, there was a lot of talk of what they called bailing on the private sector. But individual private investors are not going to go into the morass of our financial markets where there was so little transparency. Those who went in at the beginning got burned. And so I think there were—and the magnitudes involved required were just too large to be able to get that from the private sector. So one had to do something. But it could not have been done in a much worse way than the way it was done in terms of protecting American taxpayers.

Mr. LATOURETTE. And the last observation that you made, you said the retreat from mark to market would be not a good thing. And, at least from my observation, I have been told that about $5 trillion in liquidity has been taken out of the market just by the mark to market principles. And so rather than coming up with another bad regulation on mark to market or retreating from it, since there is no market for some of these assets, and that is creating the double whammy: One, you are marking down your portfolio;

and two, you have to store away more cash for safety and soundness, could we replace mark to market with something else such as intrinsic value so that we could create a level of value for an asset.

Mr. STIGLITZ. Well, I think that it is imperative to continue with mark to market. When there is no market, as is the case in some assets, obviously you can't mark to market, you have to use some other principle. The issue is what you do with mark to market. I had a very brief reference to countercyclical provisioning which takes into account what happens in these kinds of situations to market values. What I find very interesting is that those who have criticized mark to market didn't criticize it when they overestimated the prices in the bubble and haven't offered to give back the bonuses that were based on those over excessive prices when the market was excessively exuberant. They want an asymmetry where when it is too low, they will get the market up, when it is too high, they will leave it up to high. I think we have to stay with a transparent system but think very carefully about how we use that information in regulatory processes.

Mr. LATOURETTE. Thank you. Mr. Chairman, Mr. Seligman is practically jumping out of his chair to comment on the mark to market.

Mr. SELIGMAN. I don't mean to be jumping out of my chair, Congressman.

The CHAIRMAN. We worry about jumping out of our chairs all the time, or falling out.

Mr. SELIGMAN. If there is a market, not to use it runs the risk of deluding yourself. I mean, it is the essence of capitalism that we rely on markets. To suggest there is some other intrinsic value other than the markets can lead to excessive ebullience in ways that can mislead you terribly.

The CHAIRMAN. Thank you, Mr. Seligman. I am going to recognize Ms. Velazquez and take 15 seconds to say that I think what we intend to pursue, or what I hope we will pursue, is what Mr. Stiglitz said, namely that mark to market is one thing, the automatic consequences that result from that are a separate thing, and that it is possible to leave mark to market in place, but then to make sure that all these negative consequences, as the gentleman said, put more cash aside, which have a procyclical effect.

And my own view was that there is a consensus forming about a two-step process in which you have mark to market, but which you then get flexibility on the consequences. And that will be—the ranking member had asked that this be particularly part of this hearing. That will be part of our agenda next year. The gentlewoman from New York.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. If I may, Ms. Rivlin, I would like to address my first question to you. In the recent economic crisis, several of our Nation's largest financial firms received unprecedented levels of Federal resources because regulators believed that they were too big to fail. At the same time, many community banks and credit unions who did nothing to contribute to our current situation are equally affected by the crisis but have been largely left out of the Treasury's rescue plans. Given this reality, how will this affect consumers in those areas that rely upon community banks and credit unions for the credit needs, especially small businesses? Every day that we read the news, newspapers, there are different stories across the Nation where it is very difficult for small businesses to access credit.

Ms. RIVLIN. I think this is a very real problem. The hope was that at least stabilizing the major institutions first would get credit flowing and that it would help with the rest of the system. How to intervene at the community bank and credit union level is another question. Part of it, I think, goes to intervention in the mortgage markets themselves and to finding better ways and with larger amounts of money behind them to buy up the mortgages and renegotiate them so that you can keep the homeowner in the house where possible or re-sell it or re-rent it to somebody else. That strikes me, and Dr. Stiglitz mentioned this, as a really important part of this puzzle.

Ms. VELAZQUEZ. So let me ask you, Dr. Stiglitz, should a revised regulatory framework eliminate this dichotomy where some firms are too big to fail and others are too small to save?

Mr. STIGLITZ. As I said before, I think we do need to deal with the problem of the big banks and have effective antitrust enforcement. One of the things that I mentioned about the objectives of regulation should be access to finance, access to credit. I didn't have time to talk about that, but that is really very important. The community banks and the credit unions play a very important part in that. And I worry a little bit that in the rush to save the stability of our financial system, we are not focusing on in the long run, what is the most important, is access to finance. I think it would be very important to create a monitoring of where the finance is going, who is getting it, making sure that there is finance to small businesses. And that may necessitate giving some more help to the small—to the community banks, local banks, regional banks, and credit unions.

Ms. VELAZQUEZ. Ms. Rivlin, even before recent mergers and takeovers, the 3 largest banks in the United States control more than 40 percent of the industry's total assets. Should working families who have watched as their retirement accounts dwindled be concerned about this increased level of consolidation and what do we as policymakers need to consider going forward in an era of increased industry consolidation?

Ms. RIVLIN. I think we do need to worry about it. I think it is very hard to figure out exactly how to fix it. And I wouldn't want to be the antitrust judge trying this case because I don't think we know what the rules are. There was reference to Gramm-Leach-Bliley earlier; was that a mistake. I don't think so. I don't think we can go back to a world in which we separate different kinds of financial services and say these lines cannot be crossed. That wasn't working very well, nor was our older prohibition under Glass-Steagall of interstate banking. You are not old enough to remember that. But we can't go back to those days. We have to figure out how to go forward. But I think the consolidation of these huge financial behemoths is a problem.

Ms. VELAZQUEZ. But the present days are not working either.

The CHAIRMAN. Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman. I thank you all for your testimony. And like some of you, I want to see a Federal entity that supervises and ensures the safety and soundness of larger hybrid financial institutions like AIG. Second, that we need the FEC to regulate the credit default swaps market, revise mark to market accounting, enhance the credibility of credit rating agencies, reign in hedge funds, as well as market manipulations like the short selling. And third, it is essential, I think, that we work towards modernizing mortgage and credit product regulations like RESPA, TILA, UDAP and determining the fate of Fannie and Freddie. And I will assume that you all have read Paulson's Blueprint for a modernized financial regulatory structure. The model proposes that instead of the functional regulations that we create the three primary financial services regulations to focus on market stability across the entire financial system and then safety and soundness of financial institutions with government guarantee; and then third is the business conduct regulations that investors and consumers—that gives the investors and consumers protection. So I would like to know, in your opinion, is this a silver bullet structure that you can paint a picture for us as to what the ideal financial services regulatory structure would look like? Maybe Mr. Seligman. You talked a lot about the—

Mr. SELIGMAN. The Department of Treasury Blueprint started a conversation and it deserves credit for that. But in spite of the fact it was a reasonably long document, it did not seem to have the detailed understanding of the purposes of the separate regulatory agencies that do exist, understand their advantages, and understand their institutional context. I think that is important as you consider how to go forward. I thought the first tier of recommendations made more sense with respect to market stabilization. I call it a crisis manager. There are other terms. And clearly the notion that you need to have one hand firmly on the till makes sense. I thought scrapping the SEC and some of the other initiatives in the second and third tier were quite question-begging.

I was struck by a starkly ideological tone. The notion that in effect, the core principles articulated by the Commodities Futures Trading Commission, were necessarily the wisest approach to address issues like market manipulation is quite question-begging. The history of addressing market manipulation require statutes, rules, and case determinations. It is quite case-specific. Having said that, the point that was useful in that exercise, and it was like an academic exercise, was it did focus us on the fact that we are not just dealing with an immediate economic emergency, we are dealing with a fundamental changes in the dynamics that actuate regulation at the Federal level. When the underlying markets change, regulation must change in constructive ways to address it.

Mrs. BIGGERT. Thank you. Ms. Rivlin.

Ms. RIVLIN. I did read the Treasury Blueprint and I didn't think it was anything like a silver bullet. And particularly because I think as long as we do have big financial institutions, maybe they are too big, but we are going to have big financial institutions, it is very hard to separate market stability from the safety and soundness of those institutions. So they were giving one institution the market stability job, and another institution the safety and soundness job. They are very hard to separate. They would have to work together. I don't think it is a cure for the duplication. There were some other things in it that were better.

Mrs. BIGGERT. Do you think that since we are looking at systematic risk which has been such a big problem, then how do we fit that into a regulatory structure?

Mr. SELIGMAN. I would like to suggest that just as in say a national security emergency in the White House, you have one person definitively in charge of command and control under some circumstances. In an economic emergency and to prevent an economic emergency, you need someone who is unequivocally or some institution that is unequivocally in charge. And it could be the Federal Reserve System, it might be the Department of the Treasury. But it is not sufficient for it just to be reactive to a crisis. The question is, how do you provide sufficient information flow, examination, and inspection so we can avoid a crisis. The purpose of regulation is not to clean up messes but to prevent them. And in that sense one of the, I think, pivotal decisions this committee or some committee is going to have to wrestle with is, how do we make permanent a system of risk avoidance or crisis avoidance? The second ordered question, which I touched on briefly in my testimony is however that just begins the analysis. The specialized expert knowledge that some regulatory agencies have specific industries cannot easily be addressed by the crisis manager.

The CHAIRMAN. Thank you. It did strike me as we talked about silver bullets that it would have been very appropriate to have given it to the Chairman of the Federal Reserve who played the role last year of the "Lone Ranger," so he might have been appropriately armed. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman. It may be fortuitous that I am following Mrs. Biggert in asking questions because I want to actually go down the same line. It seems to me that in the 16 years I have been on this committee, most of our time has been spent trying to decide what we legislate and what we punt to some regulator to regulate. And this may be the first time that we are called on to try to address a different question that we started maybe to try to address when we were trying to set up the parameters of the regulation of OFHEO, but we started with the assumption that there would be an OFHEO.

This time, we have to figure out what the appropriate regulatory structure is. It seems to me that the question we have to ask is, how many regulators do we have? And the Blueprint that Paulson came out with at least started that discussion, I agree. You all have picked his proposal apart, so I guess my question to you is, if you picked his proposal apart, you didn't like it, how many regulators would you have and what jurisdiction or what regulatory oversight, who would you put under their jurisdiction or what would you put under their jurisdiction? And if I could get each of the four of you to address those quickly within my 5 minutes, that would be great.

Ms. Rivlin, I will start with you.

Ms. RIVLIN. I don't think I have a full answer to that yet. I think the number of regulators should be less than we have now. We clearly have quite a lot of duplication. I think the idea of combining the responsibilities of the—

Mr. WATT. How many and what would they regulate?

Ms. RIVLIN. Well, I am not prepared to give you a number like 5 or 3; what I am saying is we can combine some of the ones we have to a smaller number. I do think we need a regulator of financial behemoths sometimes known as bank holding companies that is responsible for making sure that they are adequately understanding and not monitoring their own risk. I think that is the biggest thing. We have not had that in this crisis.

Mr. WATT. Okay. We have one, one bank holding company regulator. Dr. Stiglitz, do you have one?

Mr. STIGLITZ. First, let me just begin by saying I think the issue isn't so much the number of regulators.

Mr. WATT. Well, tell me what they would regulate then? If you don't want to tell me a number, tell me in what areas we ought to be regulating.

Mr. STIGLITZ. Part of the problem is that we have had regulatory capture. So I worry that if we had one regulator like the Federal Reserve, it would be captured by the investment community.

Mr. WATT. I worry about that too, but that is a different issue. I want to know what—if you didn't have that problem, you were setting up an ideal world, there were going to be no regulatory capture, what would you—how would you organize this? That is the question I keep asking.

Mr. STIGLITZ. I think we need—let me just say, I think the cost of duplication is low compared to the cost of failure. So we need a system that checks and balances. I think duplication is fine. Overall, I think the general problem is you need to have somebody sitting on top looking at the whole system, the performance of the system. And then underneath that.

Mr. WATT. All right. We have a system regulator and we have a bank holding company regulator.

Mr. STIGLITZ. Underneath that, you have to have somebody who understands each of the parts very deeply. And those are two separate issues that can be coordinated.

Mr. SELIGMAN. The system has to be comprehensive. That means it has to address some gaping holes such as right now like credit default swaps. Second, there has to be some sort of risk avoidance or crisis manager at the top. This could be the same agency that would address things like financial holding companies. Third, you have to have sufficient expert knowledge to address a series of specialized industries including securities and investment banks, insurance, and commodities.

Mr. WATT. Those are separate regulators you are describing.

Mr. SELIGMAN. Well, I think the issue as to whether they will ultimately be separate or consolidated should be carefully explored. We have five depository institution regulators today. I think a case can be made that we don't need that many. You then have a separate issue which you haven't touched upon, which is we also have State regulation of insurance and we have State regulation of banking. How are you going to coordinate what you do at the Federal level with the States? Then you have yet another issue, which is terribly complex, and that is increasingly financial products are sold internationally. How do you coordinate what we are doing in this country with what is being done abroad?

So I think you have the right questions, but I think more evidence has to come in to flush out the answers.

Mr. WATT. I think I ran out of time.

Mr. JOHNSON. I will be brief. Since I believe that the financial regulatory system should be consolidated around bank holding companies, I think you need one bank holding company regulator. I think the Federal Reserve is already doing that. It should continue to be the regulator there. I think that their resources are inadequate and their expertise in supervision is weak and we need to concentrate on that much more. For securitization, which covers a lot of finance, you have the SEC.

Transparency, securitization, and supervising the rules of running a clearing system should be an SEC-like function. You already have one. I think it could be strengthened. But there needs to be coordination between a bank holding company regulator and someone overseeing the securities markets. There should be mandated coordination to avoid turf battles.

Mr. WATT. Thank you, Mr. Chairman.

Mr. KANJORSKI. Thank you. Mr. Barrett.

Mr. BARRETT. Thank you, Mr. Chairman. Panel, thank you for being here today. I love the idea about the select committee and I think that is a great way to start. But Mr. Johnson, let's start with you. I am sitting on the select committee and you are giving me advice today. The goal of the Federal regulation should be what, stability and growth, or to ensure that fraud and malfeasance are punished? And of the current situation, how much has been caused by lack of enforcement or lack of effective regulations?

Mr. JOHNSON. Well, certainly, I think punishing malfeasance and maintaining the safety and soundness of the market go hand-in-hand with growth and prosperity. So I think that those are one and the same thing. But in my opinion, supervisory failures have been one of the primary factors in this crisis of confidence we have had. And even though our regulatory system is overlapping and somewhat antiquated, the resources are there and the lines of supervision are there to prevent this. We didn't prevent it because we failed to detect systemic risk. That is one of the reasons why I argue that if you try to create a pervasive financial regulatory system, it can't be policed by the public sector because we are already failing now. So we ought to focus our regulatory and supervisory efforts narrowly and pour in all the resources necessary along with strong accountability to make it work. We can't control everything. And it would be a miserable failure if we tried.

Mr. BARRETT. Mr. Seligman.

Mr. SELIGMAN. I agree with Mr. Johnson that there have to be multiple objectives, and clearly law enforcement would be one of them. I think that when you look at the recent failures, the reality is the failure of inspection, examination, and supervision is a pivotal part. The Office of Inspector General of the Securities and Exchange Commission recently did a report on Bear Stearns. And it noted that among other apparent causes of the failure, there were rules that didn't adequately address liquidity, the Commission did not have sufficient staff to engage in sufficient examinations, and it did not respond to red flags in a meaningful way.

Apparently someone on the staff changed the requirement that was in the so-called consolidated supervised entity structure of the SEC that you use outside auditors to internal and that didn't rise to the Commission's level for review. There wasn't a sense as you saw the Bear Stearns devastation in the spring that you almost needed to say what is going on here, how systemic is this, this is a crisis, we have to look much harder and change rules much faster than we would otherwise.

There were a lot of different causes. Sometimes regulatory agencies have the right rules, sometimes even the right people, but don't have the right sense of urgency. Too often, though, what you find is they are understaffed, they are underbudgeted and they get stuck in a kind of rut of doing the same things over and over again and don't respond effectively to changes in fundamental dynamics.

Mr. BARRETT. That is a great point. And Dr. Stiglitz, I want to ask you, following up on that, do you think our regulators have enough discretion to make decisions to modify these rules? I mean, is that part of the problem, they feel like they are locked in and they can't make some decisions if the rules change, if all of a sudden the environment changes are they afraid to make decisions?

Mr. STIGLITZ. Well, I think part of the problem in the past has been that we have had regulators who didn't believe in regulation. So that for instance, it was noted earlier that the Fed had authority, more authority to impose regulations than it used. And it wasn't until Bernanke became the Governor that additional regulations were imposed but it was like closing the barn door after the horse was out. So they had more authority than they used. And that is why I keep coming back to the issue of the incentive of the regulators. And it also comes back to the design to the rules. The rules need to be, I think, simple enough that there is, and transparent, so that everybody, including Congress, can see on an ongoing basis whether there is enforcement. And that means for instance restricting in the core part of our financial system the commercial banks the engagement, the use of some of the derivatives, particularly the nonstandardized derivatives so you can't see what is going on.

Mr. BARRETT. Thank you, sir. I think my time is up. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. The gentleman from New York.

Let me say we have talked to the witnesses, and we do want to hear from industry people. We are going to break this panel at 12:30. A couple of the witnesses have time constraints. We will immediately go into the next panel, and we will begin the questioning where we left off.

I would also advise members if you could find any place in this area in the building that is serving lunch, on our side at least, if members want to go and come back, no one will lose his or her place because of that. We do want to try to accommodate people in that regard.

The gentleman from New York is now recognized.

Mr. ACKERMAN. Thank you, Mr. Chairman.

Damon Runyon, less famous for being born in Manhattan, Kansas, than writing about Manhattan, New York, didn't write about or create characters on either Main Street or Wall Street, but more on 42nd Street for plays like Guys and Dolls. He created characters that included street hustlers, gamblers, and book makers. If he could create a character here who was looking at this subprime mess that we are in, he would probably create one who wanted to ask a question that went something like: How can you make book on a horse that ain't never run before?

And I guess I would ask that question, because there is no other character here.

The CHAIRMAN. Does the song follow this?

Mr. ACKERMAN. Thankfully, no.

The CHAIRMAN. Okay.

Mr. JOHNSON. I will comment on that. I think you are making the point that well, okay, if somebody creates a new security that has never really been used before so you don't know how it might perform—

Mr. ACKERMAN. My gosh, you have it.

Mr. JOHNSON. —how do you know that it is safe and sound and will not add instability to the system? The truth is, you don't. But the key to that is transparency. When you register a security, you should be required to reveal every aspect of that security. The over-the-counter markets in debt securities lack in transparency.

Mr. ACKERMAN. Should you be putting a credit rating on a product that is not rateable because it has no history?

Mr. JOHNSON. I don't believe in the credit rating agencies' ability to get it right. I think the market can determine those things.

Mr. ACKERMAN. But you can't bet on a horse unless you look at the morning line and see what the odds are.

Mr. JOHNSON. Yes. I just think full disclosure is the best policy.

Mr. ACKERMAN. Okay.

Mr. JOHNSON. If a horse has never run, you still don't know, but an informed investor can decide for himself. Rating agencies have been miserable failures as forecasters.

Mr. ACKERMAN. But if an investor is told the odds are 5 to 1 or 2 to 2 or whatever the odds might be—or the odds are AAA—

Mr. JOHNSON. Well, you can have rating agencies that want to put out ratings and you can read them if you want. But mandating reliance on ratings is a mistake.

Mr. ACKERMAN. Volunteer rating agencies. Okay.

Mr. JOHNSON. Okay.

Mr. SELIGMAN. Let me just say a kind word for credit rating agencies. I don't think anyone does anymore. But to the extent they are independent of internal management, even with all the conflicts of interest, they give you a fresh set of eyes.

Mr. ACKERMAN. Should the owner of the horse pay the bookie to rate the horse?

Mr. SELIGMAN. You are out of my area of expertise. I know about securities, but I don't know about bookies.

Mr. ACKERMAN. Should a company that is creating securities pay for their own rating?

Mr. SELIGMAN. It happens, currently.

Mr. ACKERMAN. I didn't ask you if it happens currently. We all know who is paying to get a AAA.

Mr. SELIGMAN. I appreciate that. But the question is, if you eliminate it, how do you evaluate quality?

Mr. ACKERMAN. How about if we created a system where you can only rate things—if you are a recognized rating agency, you can only rate things that are rateable and have an experience rating? And not to stifle creativity, you can package it, do whatever else you want to structure up by saying these products have never run before, they don't have a rating, they are three-legged horses; if you want to bet on them, buddy, you are on your own.

Mr. SELIGMAN. Clearly, there are different ways you can structure access to the credit rating agency, create different rules. All I am suggesting is the headlong rush right now to in effect eliminate that as a vehicle for giving some independence—not great, but some independence—and a separate set of eyes is something we may regret if we move too quickly.

Mr. ACKERMAN. Okay. Ms. Rivlin?

Ms. RIVLIN. Two points. I think we should have rating agencies paid by the buyer, not the seller. The buy side, not the sell side. I think that would be fairly simple. It wouldn't—

Mr. ACKERMAN. An independent sheet?

Ms. RIVLIN. Pardon? You would have the major investment funds pay a small fee to support rating agencies rather than the sellers of securities.

But another point. You said earlier that there was no record on the mortgage-backed securities backed by subprime. Actually, there was, and the record was pretty good. As long as prices were going up, defaults on subprime were minimal. So the rating agencies weren't absolutely wrong in using the past. It just wasn't—

Mr. ACKERMAN. What if there was no past?

Ms. RIVLIN. Well, no, there was a past. Subprime mortgages didn't start in 2006. There was a history. Ned Gramlich has set this out rather nicely in his book. But the problem was as long as prices were going up, housing prices, there were relatively small defaults on subprime. So using that history—and there was a history—was misleading. As soon as we got to the top of the housing market, all the rules changed.

Mr. ACKERMAN. As long as all the horses are winning, you don't care what you are betting on. That is the market going up.

The CHAIRMAN. It is post time for the next race. The gentleman from Georgia.

Mr. PRICE. Thank you, Mr. Chairman.

I am not sure how my running shoes are these days, but I will give it a try. I want to thank each of you for your comments. And I want to have you speak specifically about the issue of regulation, deregulation. Each of you mentioned in varying degrees of certitude that the issue wasn't whether or not we had more regulation or less regulation; it was that we had the right regulation.

There seemed to be some, however, who still hold to the notion that there was this fanciful groundswell of deregulation that was the cause and genesis of our current situation. I have heard that the situation regarding the lack of regulation, or appropriate regulation, was due to resources, personnel, sense of urgency, lack of flexibility, all those kinds of things.

I wonder if each of you would comment very briefly about this notion that it was deregulation that was the cause of where we are right now. Ms. Rivlin?

Ms. RIVLIN. I don't think it was so much deregulation as failure to recognize that the markets were changing very rapidly and that we needed new kinds of regulation.

Mr. PRICE. The nimbleness and flexibility.

Ms. RIVLIN. That certainly is mortgage markets' story, derivatives' story.

Mr. PRICE. Correct.

Ms. RIVLIN. And we didn't do that. There were people who might have done that who were opposed to it, like my former colleague Alan Greenspan.

Mr. PRICE. Right. Dr. Stiglitz, would you?

Mr. STIGLITZ. I think I agree. It was the deregulation philosophy. And that led them not to use all the regulatory authority that they had. There was a need, probably, for more regulation in certain areas; for instance, the mortgage market that we have been talking about.

Mr. PRICE. Could it have been accomplished under the current structure with the right individuals?

Mr. STIGLITZ. Probably, under the current structure. But if you had an attentive regulator, if he didn't have that authority—

Mr. PRICE. Right.

Mr. STIGLITZ. —he would have gone to Congress and said, look, these things are dangerous. And in terms of the question that was asked before—

Mr. PRICE. I want to run down the panel.

Mr. STIGLITZ. Dangerous—what I want to say is you have to ask about not only the recent experience, but knowing the fact that house prices can go up, but they can also go down. And you have to ask not only what has happened in the last 5 years, or even 10 years, but what would happen if the prices returned to—or say the price-income ratio returned to a more normal level—

Mr. PRICE. Right.

Mr. STIGLITZ. —what would happen?

Mr. PRICE. Mr. Seligman?

Mr. SELIGMAN. I think when you look, for example, at the Bear Stearns report prepared by the Office of Inspector General, a legitimate question can be asked whether or not the people who were in charge of enforcement there actually believed in it. That is a question of a deregulatory philosophy. And it may not be—

Mr. PRICE. But it is a deregulatory philosophy, not the act of deregulating it. Would you agree with that?

Mr. SELIGMAN. In that specific instance, yes. More broadly, though, when you look at much more serious issues such as the loopholes for credit default swaps, and the lack of coverage of hedge funds, these are areas where a broader deregulatory approach may not have served us particularly well.

Mr. PRICE. Thank you. Mr. Johnson?

Mr. JOHNSON. Yes, I don't believe the mentality of deregulation was the cause, but if you are going to have a Federal safety net and protect deposits, then you have to regulate and supervise the banking system, and you have to do it very well.

Mr. PRICE. And—

Mr. JOHNSON. Because the taxpayer is extremely exposed. My view is that the safety net ought to be as narrow as you can make it to allow the market to work, but the market only works if failure is part of that process.

Mr. PRICE. Right. Thank you. I think we all are interested in appropriate regulation, not an absolute unregulated system.

I want to touch, in my remaining few moments, on a concern that I have that much of the criticism of what has gone on I believe to be an attack on the capitalist system of markets and the ability to take risk and realize reward.

I wonder if you might comment briefly on whether or not financial regulators should try to reduce systemic risk by setting limits on private risk-taking. Ms. Rivlin?

Ms. RIVLIN. I think we need limits of various kinds on leveraging. I think we were overleveraged in many respects. And in respect to the derivatives, I think—or even the credit default swaps—was the basic problem that we had credit default swaps or was it the people who were trading them were way overleveraged? And I would worry about the overleveraging.

Mr. PRICE. Dr. Stiglitz, private risk-taking?

Mr. STIGLITZ. I think the core point is that at the center of the financial system, the commercial banks, our credit system, pension funds, people who are using other people's money they don't have—that has to be ring fenced. Outside of that, if you can ring-fence that core part, if people want to engage in gambling, and we allow them to fail because it won't have systemic consequences, that is fine. Let them gamble. But in that center part, we do have to restrict risk-taking, because we will pick up the pieces when it fails, as we have seen.

Mr. PRICE. Thank you. Mr. Seligman?

Mr. SELIGMAN. I think the whole purpose of a Federal financial regulatory system in part should be to fortify capitalism, to make it more effective. It is not an attack on capitalism. It is, rather, a way for it to work most effectively.

Mr. PRICE. Mr. Johnson.

Mr. JOHNSON. Yes, I don't have anything to add. I agree with that.

Mr. PRICE. Thank you very much. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Next we have Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman.

I don't want to resume the horseracing, but let me just try to follow up some on the end of what Mr. Ackerman—I believe what he was driving at. And you know, I know that in New York, for example, our attorney general has begun an investigation into this issue called short selling. It seems as though, you know, one can get an unfair advantage—and I think that is where Mr. Ackerman was going—in races if you have the spread of false information going out. And it seems as though in short selling it can, because of false information, even though it is an illegal act, affect the price of stock. And you can indeed have a manipulation of the market in that regard.

So my question then is—and I know Mr. Ackerman has a bill in this nature—that as a possible response to the possibility—or to market manipulation through short-sell misinformation, should the Federal Government reinstitute the uptick rule and evaluate calling in all the outstanding shorts on financial stocks to get a true cash price discovery at this time?

Mr. SELIGMAN. You know, the short-sale rules were adopted by the Securities and Exchange Commission in its earlier financial emergency in the 1930's, and initially included the uptick rule. And it should be reexamined.

But I think the current debate with respect to short selling has focused exactly on the point you just raised, the notion that false rumors and short sellers were driving down financial institutions. What I don't think is fully apparent yet is a number of investigations have been launched by the Securities and Exchange Commission, and, I suspect, by the Justice Department as well. False information is fraud. It is criminally wrong today. It is civilly wrong today.

In the next few months, we will see whether or not existing Federal laws will provide a strong enough deterrent so we are less likely to see the dissemination of false rumors in the future. I do not think, though, that the uptick rule is a silver bullet or a magic wand. It is a regulatory device. It may or may not be appropriate. But it is not the real issue here. It was the belief that financial institution stocks were being pounded down in an inappropriate way. And at the time, the enforcement mechanisms were too slow to act.

Mr. MEEKS. So you don't believe that the uptick rule would at least—because what happens is the speculation or the thought that maybe it was—and I agree, the investigations have to go on, and we have to find out what did or did not take place. But the confidence in the market or the thought and the rumors that go out that it is being manipulated, if we can prevent that, because all of the markets are based upon confidence. And if the confidence—if the uptick rule helps restore confidence, does that help further stabilize, you know, stabilize the markets as a regulatory tool?

Mr. SELIGMAN. The uptick rule will slow market declines. It won't prevent them. And when we have seen the securities markets overwhelmed with sales recently and driven down hundreds of points in a day, I am very skeptical the uptick rule would have made much difference.

Mr. MEEKS. Yes, ma'am.

Ms. RIVLIN. I agree with Mr. Seligman. But I think probably the uptick rule would have helped, and we ought to put it back.

Mr. JOHNSON. I agree with Mr. Seligman that the uptick rule might slow things, but it won't stop the fundamentals. The key to avoiding manipulated short selling, or for that matter, manipulated long purchases as well, is transparency. If investors really knew what was on the balance sheets of the organizations that were being traded, and you had financial statements that accurately portrayed this on a regular basis, it would be very difficult for false rumors to develop. And so I would just encourage better preparation of accounting, financial statements, and maybe more regular disclosure.

Mr. MEEKS. Let me ask this last question, because my time is running out. You know, my Governor, David Paterson from New York, last week he said would begin regulating credit default swaps. And he said that regulation is going to take effect on January 1st. But he asked me, he said, "Hey, what about the Federal Government? Will it take steps on its own to oversee the credit default swaps?"

And so the question that I would like to ask you really quick is whether or not the Federal Government should follow the lead of New York and, specifically, should we regulate them as insurance products under a Federal insurance regulatory—

The CHAIRMAN. I am going to ask for very quick answers. When members ask questions at the timeline, you really can't expect an answer. If one wants to give an answer, the others can answer in writing if they would, in fairness to members. Does anyone want to take a shot?

Mr. SELIGMAN. Credit default swaps should be regulated at the Federal level. But I think we need to work through the appropriate regulatory agency to address them.

The CHAIRMAN. Thank you. Now, the ranking member has asked me—there are a number of members who wanted to talk to this panel—he has agreed he has four members left who will take 3 minutes each. I won't cut our people off, but that way we can probably—I know somebody had to leave at 12:30—if we can stay until 12:40, we can finish, if that is all right.

Mr. BACHUS. Mr. Chairman, I know Mr. Manzullo is protesting. My alternative would be to let—

The CHAIRMAN. We lose time by discussing it.

Mr. BACHUS. —one person do 5 minutes and then it would be over. Or I can let three of you do 3 minutes.

Mr. MANZULLO. I am asking for 10 minutes.

The CHAIRMAN. I just ask the gentleman to give me—I mean this has to be settled on your side. The witnesses do have to leave.

Mr. BACHUS. We will let Mr. Garrett have 5 minutes, and we will close out our hearing.

The CHAIRMAN. The gentleman from New Jersey. We can go until 12:40, so if the gentleman from New Jersey wants to go—we are eating up the time by arguing about the time.

Mr. MANZULLO. Mr. Chairman? With all deference, if we are given 5 minutes here, I don't think it will take that much longer.

The CHAIRMAN. Well, the gentleman, there are three before, it would take another 40 minutes or so before we reached the gentleman. And that is over the time that we would be keeping people.

Mr. BACHUS. I have proposed that all our members who are here have 3 minutes, Mr. Manzullo, and you wouldn't—under this proposal, you would get 3 minutes. Under the original proposal, you would get zero.

Mr. MANZULLO. Okay. That is fine.

The CHAIRMAN. What is the verdict?

Mr. BACHUS. We are at 3 minutes apiece.

The CHAIRMAN. Mr. Garrett for 3 minutes.

Mr. GARRETT. I will talk really fast. My first point is, I appreciate your comment with regard to a select committee. I should point out the fact, and Mr. Barrett raised that issue as well, the benefit of that—Marcy Kaptur, the gentlelady from Ohio, a former member of this committee, has a bill to that effect, and I have supported that as well. I appreciate your opinion at the end as far as going on that.

Secondly, I do have several documents that I will put into the record and won't go through them all now. Most important, though, is from the American Enterprise Institute by Peter Wallison, "The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac," in which he says—and I will put that in for the record—the government takeover of Fannie and Freddie was necessary because of the massive loans of more than a trillion dollars of subprime, all of which was added during the 2000 and 2005 period.

He goes on to say Congress did not adopt strong government-sponsored enterprise, GSE, reform until the Republicans demanded it as a price for Senate passage of the housing bill in July of 2008. It led invariably to the government takeover and the enormous junk loan losses to this point.

And three other points from the Wall Street Journal and the New York Times, which, without objection, I will enter those into the record.

Finally, on this point of entering information into the record, I go back to the opening comment by the chairman. And I do want to make sure that the record is clear where we all were on this issue going forward. In committee markup on May 25, 2005, I offered an amendment to direct the new regulator to establish limits on the GSE portfolios in the case of any issues of safety and soundness or possible systemic risk. That was opposed by the chairman. At the same committee markup on that day, Representative Paul offered an amendment, 1–H, to cut off the Fannie and Freddie $2 billion Treasury line. The chairman opposed that amendment for reform.

Floor action was then taken October 26, 2005. Amendment was offered to strike language in the bill that would raise conforming loan limits to allow GSEs to purchase more expensive, riskier homes. Again that amendment failed, and the chairman opposed it.

Floor action on the same day by Representative Leach offered an amendment to give the newly created regulator greater authority to impose capital strictures on GSEs. Again, the chairman opposed that reform.

Floor action on the same day by Representative Royce, who was here earlier, amendment 600 to authorize a regulator—this is important—to require one or more of the GSEs to dispose or acquire assets or liabilities if the regulator deems these assets or liabilities to be potential systemic risk—in other words, all those toxic risks we are talking about—to the housing or capital markets. The gentleman, the chairman opposed that reform.

Floor action on the same day by Representative Paul, offered amendment 601 to eliminate the ability of Fannie and Freddie and the Federal Home Loan Bank to borrow from the Treasury. The amendment failed. The chairman opposed.

I do want to give credit where credit is due. Just this past week, a gentleman from the other side of the aisle said, "Like a lot of my Democrat colleagues, I was too slow to appreciate the recklessness of Fannie and Freddie. I defended their efforts to encourage affordable homeownership. In retrospect, I should have heeded the concerns raised by the regulator in 2004. Frankly, I wish my Democratic colleagues would admit it, when it came to Fannie and Freddie we were wrong."

This was stated by Representative Davis from Alabama. I appreciate his sign of intellectual honesty as to where we came from and how we got here.

The CHAIRMAN. I now recognize myself for 5 minutes. The gentleman's 3 minutes has expired. And let's talk about intellectual honesty. The gentleman said that he offered an amendment. I have the roll calls here. I am going to put them in the record, the list. He offered an amendment in committee. It was withdrawn. It never went to a vote. There were two amendments offered by Republicans in 2005 that went to a vote. They were both defeated, with a majority of Republicans voting against them. He kept saying "the chairman." I don't know if he meant Mr. Oxley or me, but we voted pretty much the same there. So the fact is the gentleman from New Jersey did offer an amendment. He said earlier he offered amendment after amendment. In his head, maybe, but on the Floor, he offered one, which was withdrawn. Mr. Royce had one that was defeated 53–17. There were 30-some odd—37 Republicans on the committee. Then we had one from Mr. Paul that was defeated 14 to 56.

The gentleman from New Jersey just mentioned the amendment offered by Mr. Leach on the Floor. That was defeated. And the point was he said the Democrats stopped it. This is a serial violator writing on the mirror, "Stop me before I don't legislate again."

Here is the vote on the Leach amendment. He said I opposed it. I did. So did 377 other Democrats and 190 Republicans. The vote on the Leach amendment, now you want to talk about intellectual honesty, blaming the Democrats for defeating an amendment that lost 378 to 36, with 190 Republicans voting against it, does not seem to be accurate.

He then talks about the amendment he offered on the conforming loan limits. On the conforming loan limits, on agreeing to the Garrett amendment, it failed 358 to 57. There were over 220 Republicans in the House; he got 57 of them.

Now I know it is a bad feeling not to be able to get your own party to be with you. I understand the gentleman's distress that he couldn't get a majority of his own party, and on a couple of these amendments was thoroughly repudiated. The majorities aren't always right, but they are who they are.

So this fantasy that the Democrats stopped it is simply untrue. I am going to put these into the record as well. They are the roll call votes from the committee and on the Floor. And the fact is in committee in 2005—now the committee did vote the bill to the Floor 65 to 5. It is a bill mentioned favorably by the people from FM Watch. The gentleman from New Jersey was one of the five. But a great majority of the Republicans voted against him. It is legitimate to talk about this. But saying it was the Democrats that did it and the Democratic—excuse me, the Democrat Party that did it, when in fact it was a bipartisan majority that repudiated all the gentleman's efforts, does not give a fair presentation. So we will put these in the record: 378 to 36; 357 to 58.

In committee, to correct what the gentleman said, he did not push his amendment to a vote. Apparently, it was withdrawn. I guess the gentleman, he said I opposed it. So when I opposed the amendment, he withdrew it. I had not thought the member from New Jersey to be a man of such delicacy that the mere opposition by me would lead him to withdraw the amendment. I wasn't the chairman. I think it was the fact that he knew this would be another one where he might get only 7 or 8 votes and be somewhat embarrassed by it. But I will put all these in the record.

There are zero cases—we are talking 2005 now—zero cases on either the Floor of the House or in committee where an amendment offered by a Republican was defeated even though it had a majority of Republican votes. Yes, Democrats voted against them, in almost every case joined by 90 percent of the Republicans, sometimes only by 60 percent of the Republicans.

And then came 2007, when the bill was passed that the FM Watch said worked. And the gentleman had quoted someone as saying, "Well, it didn't pass until July, when the Republicans—the Democrats agreed to do it for some reason." Here are the numbers. This committee organized under a Democratic Majority on January 31, 2007. On March 28th, we passed a very strong bill, supported by the Administration, and approved by FM Watch. We then asked the Secretary of the Treasury to put it in the stimulus package because we were afraid of Republican and Democratic inaction in the Senate, a bipartisan problem. The Secretary felt he couldn't do that. We then pushed for it to be adopted in the bill. Senator Dodd was pushing for it. It was held up for a couple of months by filibusters by Senator DeMint and Senator Ensign on unrelated matters, but it finally passed in July.

So the fundamental point is, yes, it is legitimate to talk about differences, but this portrayal that the gentleman was valiantly trying to rein in Fannie Mae and Freddie Mac in 2005, and he was frustrated by the Democrats is, of course, implausible because we are talking about the House run by Mr. DeLay, which was hardly one where the Democrats were able to stop Republicans from doing what they wanted. But the record clearly goes in the opposite direction. These amendments he talked about, and which he sort of implied that the Democrats had blocked these Republican efforts, are fantasies. They don't exist.

Mr. BACHUS. Mr. Chairman?

The CHAIRMAN. Yes. The gentleman is asking me to yield? I don't yield. I am using my time. Oh, my time has expired. My time has expired.

The gentleman from Illinois is recognized for 3 minutes.

Mr. MANZULLO. I thank the chairman. In 2000, this committee, through the efforts of Richard Baker, began a more intensive focus on the potential systemic risk posed by Fannie and Freddie. In an effort to lobby against Mr. Baker's bill, Fannie Mae engineered over 2,000 letters from my constituents in my district concerned about the "inside the Beltway" regulatory reform bill. That was a reform bill in 2000. The problem was the letter campaign was a fraud. My constituents did not agree to send those letters. And what ensued was a confrontation with Mr. Raines in which he arrogantly claimed Fannie did nothing wrong in stealing the identities of 2,000 of my constituents. At that point, I threw the Fannie Mae lobbyists out of my office and said, "You are not welcome to come back." That was 8 years ago.

Then again in 2004, there was a confrontation between myself and the head of OFHEO over the fraudulent accounting motivated by executive greed and Mr. Raines, who took away $90 million. That led to a lawsuit, and he unfortunately had to give back only $27 million of that. And I cosponsored the reform bills in 2000 and 2004, and again—2003 and 2005.

Dr. Rivlin, I have been one of your biggest fans, even though you don't know that, because you make astounding statements such as on page 3, "Americans have been living beyond our means individually and collectively." You talk about personal responsibility. You also talk about commonsense regulations, that you should not be allowed to take out a mortgage unless you have the ability to pay for it and have proof of your earnings.

My question to you today is, as we discuss restructuring and reform, what kind of changes or curbs should be placed upon GSEs in your opinion?

Ms. RIVLIN. I think you have a really hard problem with the GSEs, because the problem was that they were structured in such a way that they had very conflicting missions. They were told they were private corporations, owned by stockholders, responsible to those stockholders to make money, and they were also told that they had public responsibilities to support affordable housing. And they interpreted those—they came late to the party on subprime, but they came, as you pointed out, in a very big way. And that turned out to be part of fueling the collective delusion. And then they got caught in a really big way when the market—when the crash happened.

I think the real problem going forward is how to unwind this untenable situation. Either you have to have Fannie and Freddie being truly private institutions with no government guarantee, in which case they have to be a lot smaller—that would take a long time to accomplish, but it is one model—or they have to be fully regulated, with the rules clear what they are to do in the mortgage markets, and that they should lean against the wind when a bubble seems to be getting out of hand. That is another possible model. But the thing that isn't possible is this combination of conflicting incentives.

The CHAIRMAN. If the gentleman wants to ask one last question, I will give him the time.

Mr. MANZULLO. That is fine.

The CHAIRMAN. Okay. The gentleman from Kansas.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman.

Ms. Rivlin and others on the panel who would care to comment, my question is this: The events of the last few weeks have resulted in extraordinary intervention by government, designed to stem the growing crisis. But there is still pessimism, and questions about whether what we have done will work. Are there further actions that can and should be taken by the Federal Government to restore confidence in our financial markets and institutions?

Ms. RIVLIN. I think part of it is not in the jurisdiction of this committee, it is stimulating the economy itself. You are going to need a stimulus package. I think it should be quick, it should be temporary, it should be targeted, but it should be big to get this economy turned around.

Mr. MOORE OF KANSAS. How big?

Ms. RIVLIN. How big? Oh, I don't know, $2-, or $3 billion. Big stuff, but carefully crafted. And you also need to go to the problem of the homeowners themselves, and getting as many people to stay in their homes, if they can pay, as possible. I think those are the bigger things than fixing the regulatory mechanism right now.

Mr. STIGLITZ. I think there are four things. The first is the stimulus, and it has to be large, I think 2 or 3 percent of GDP. It has to be carefully crafted. But given the mountain of debt that we have inherited, that means we have to focus on things with big bang for the buck. Preferably automatic stabilizers, at least a large part, to recognize the fact that there is some uncertainty. So aid to States and localities, absolutely essential to fill in the gap in their revenues. Extended unemployment insurance. But I also think a strong infrastructure.

Second, I think we need to do something about the foreclosure problem. I think that needs to be done quickly because prices are going to continue to fall, and there are going to be more foreclosures, the hemorrhaging I talked about before. And that needs a comprehensive approach.

We need, I think, aid to lower-income people like we have had aid to—we pay 50 percent through our tax system, many States, for the housing costs of upper-income Americans. We contribute nothing to lower-income Americans. We need a bankruptcy reform; what I call it, a homeowners' Chapter 11. And we may need, and I think we probably do, government participation taking over some of the mortgages to help—and passing on the low-cost interest that the government has access to to help homeowners.

Third, as I said, I don't think we are going to restore confidence unless we begin the regulatory reforms. Because why should anybody believe that the financial system that has failed so badly change their behavior without more fundamental reforms?

And fourth, I think that we need to more comprehensively address the problems of our financial system that we have been talking about. That is necessary to restore confidence.

Mr. MOORE OF KANSAS. Thank you. Any other comments? If there is time. If there is not—

The CHAIRMAN. The gentleman has a minute and 15 seconds. I am sorry.

Mr. JOHNSON. I am not as big on a stimulus package. I think a lot of short-term, targeted stimulus would have a very short-term effect, and is wasted money. If I were going to do anything on the fiscal side, I would enact permanent across-the-board tax rate reductions to all classes. But I think that the better thing to do right now is to focus on resolving this crisis of confidence through the regulatory measures we are talking about today.

I think the Federal Reserve has already stopped the bleeding regarding the risks of deposit runs. And so I think that issue is pretty much covered.

There are still a lot of issues about the uncertainty of balance sheets of the financial institutions. Those need to be resolved as fast as possible through restructuring, acquisitions, and even failures.

I am in favor of those who made failed investment decisions being resolved through having their good assets merged and acquired by others. There are trillions of dollars still on the sidelines not willing to take a risk now but looking for an opportunity to be new participants in the financial markets. Give them a chance. Why work with the institutions that have failed and are sitting around with toxic assets on their balance sheets and can't make a move? You know, I understand the point about getting those assets off the balance sheet, but take the good assets and give them to someone who can put them to use.

Mr. MOORE OF KANSAS. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Alabama will be our last witness, the last one to question this panel.

Mr. BACHUS. Thank you, Mr. Chairman.

Mr. Chairman, I do want to say this. And I have—and I am not going to depart from this. I have not tried to pin blame or engage in partisan politics. I do want to say this: Whatever else was said about the gentleman from New Jersey, Mr. Scott Garrett, he did vote right. His vote was right. Had the majority of members followed his lead, we could have avoided some of the problems we had today. Now—

The CHAIRMAN. Would the gentleman yield?

Mr. BACHUS. Yes.

The CHAIRMAN. That is very generous of the gentleman, since he was one of the ones who voted with us and against the gentleman. So I appreciate—

Mr. BACHUS. I am just saying that his votes, they were not only right on the amendment where he voted with you, he was right on final passage where he voted differently than you did. But I am just saying that I compliment him.

Now, let me ask this question. Professor Stiglitz, back when we were doing the Fannie and Freddie Mac bailout, you were very opposed to that. You called it an outrageous and old form of corporatism passed off as free enterprise. Further, you warned the amount of potential liability that we undertook when we passed the blank check we just don't know. You said it was the worst kind of public irresponsibility. You said that we are in the worst of all possible worlds right now. And I and most of my Republican colleagues in the House agreed with you, and we opposed that bailout.

Do you still hold the same view that it was a mistake, which was our view?

Mr. STIGLITZ. Well, let me make clear we had a gun pointed at our head. And the question was—

Mr. BACHUS. No, I agree. I have used that very term, that we had a gun to our head on that one and on the one 2 weeks ago.

Mr. STIGLITZ. Exactly. So the point I was trying to raise is there were other ways of handling the problem that I was encouraging Congress and the Administration to think about. And that—

Mr. BACHUS. What should we have done? And okay, I am agreeing with you. What should we have done as opposed to that?

Mr. STIGLITZ. For instance, on some of these there was the possibility of a debt-for-equity swap so that if you—you know, we bailed out the debt holders, the bond holders, as well as—even when the equity owners took a beating. There were huge amounts of increases in the value of the debt. And I was also concerned at the terms at which the money was being provided. And you can see one piece of evidence that we got—two pieces—three pieces of evidence that we got a very bad deal in the way it was administered by our Secretary of the Treasury is the fact that most of the companies, when it was announced they were going to get an equity injection, their share price went way up.

Second, you compare the terms that we got versus the terms that Warren Buffett got, there is absolutely no comparison.

Third, you look at the terms that we got versus the terms that the U.K. Government got, there is no comparison. So I was concerned—

Mr. BACHUS. Well, now, are you aware that I proposed capital injections with covered bonds or lending or, you know, backup private equity? But we did get a 5 percent rate of return that goes to 9 percent.

Mr. STIGLITZ. Yes. But Warren Buffett, on equity injection to arguably one of the better capitalized and best capitalized investment banks, got 10 percent. And his warrants were far better than the warrants that we got.

Mr. BACHUS. And I agree that, you know—I agree. But I think at least in this bill we got a better deal than what we were going to get in buying the worst of the assets.

The CHAIRMAN. I do have to remind the gentleman the 3-minute deal was his deal.

Mr. BACHUS. So we are through.

The CHAIRMAN. We are way over it. I thank the panel. The panel is excused.

The next panel will check in. We will begin the questioning with—all right. Can we move quickly, please? Have the conversations outside. Would the witnesses and our staff please talk outside? Would the witnesses please leave? Members who want to talk to them, do it outside. I thank the members of the second panel for waiting. It is very important that we have the testimony from industry representatives going forward. We have heard and will hear in the past from consumer representatives. We will hear from people who are in the physical parts of the economy. We will hear from organized labor.

The witnesses properly said, I think, and I want to say I thought the gentleman from Georgia, Mr. Price, raised very important philosophical questions that we have to deal with. We are here talking about some of the most important basic principles in government, about how in a free enterprise economy you do or don't regulate. And I look forward to a serious debate in this country, beginning when we come back, on the appropriate economic philosophical principles. I think the old discipline of political economy is going to come back as we talk about these. And we will be very careful.

These are historic decisions that are being made. And you know, we have a silver lining to the cloud. The cloud, of course, is the terrible shutdown of economic activity. The silver lining is that nobody is doing any good things or bad things right now. So that the notion that we have to rush, I think, has been alleviated by the fact that not much is happening, and that gives us time to do this right. It is as important a set of economic decisions as I think this country will be making since the Depression, and I am determined, and I know the Minority is as well, that we will work together to do this.

With that, we will begin with our former colleague and member of this committee. Fortunately, he wasn't around at any of the times we are fighting about, so he can stay above the battle.

Our former colleague from Texas, on behalf of the Financial Services Roundtable, Mr. Bartlett.

STATEMENT OF THE HONORABLE STEVE BARTLETT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE FINANCIAL SERVICES ROUNDTABLE

Mr. BARTLETT. Thank you, Mr. Chairman, and Ranking Member Bachus. I provided in my written testimony a description of the size and scope and some examples of the problem of the regulatory system as it now stands. Suffice it to say that in summary it is a lack of coordination, a lack of uniformity, huge gaps in the system in which literally hundreds of agencies are not even authorized to talk with one another about their regulatory structure or regulatory conclusions, much less to engage in a consistent regulatory coordination. As you noted, Mr. Chairman, that will be entered into the record.

The current crisis has erupted. And when the current crisis erupted, literally no coordinating body was clearly responsible, and so it was an ad hoc response that required all the agencies, and including Congress.

So today we bring ourselves—and Mr. Chairman, I commend you and the members of the committee. This is an extraordinary hearing, with an extraordinary turnout. It may be the first that I can recall during this time, this season, in which this many members of the committee would come on a legislative effort such as this.

The hearing is timely. It is urgent. And I think it requires some relatively rapid action. I propose today, Mr. Chairman, I would share with you five near-term regulations the Financial Services Roundtable have. These are—I call them "no regret moves" in that they won't stand in the way of long-term solutions. And I believe that the committee and the Congress will consider and adopt long-term solutions in short order. But on the near-term, and these near-term solutions should lead to those longer term restructuring, I would cite five.

First, is market stabilization. Reduce the potential for systemic risk by giving the Federal Reserve Board overarching supervisory authority over systemically significant financial services firms that seek access to the discount window. And provide that statutory authority in advance of the crisis, not after the crisis.

Second, interagency coordination. Our proposal in the short term is to expand the membership and mission of the President's Working Group by statute to make it more forward looking. The fact is the President's Working Group is the only authority at all with any coordinating authority. They have no statutory authority. And on that group is not the OCC, the OTS, the PCAOB, or any insurance regulatory agency.

Third, adopt principle-based regulation. The principles should be adopted by statute by Congress. Enact those principles to serve as a common point of reference for all regulatory agencies as encompassed.

Fourth, is prudential supervision. Encourage the early identification of potential risk by the application of prudential supervision by all financial regulators for all financial services forms.

And fifth, is adopt financial insurance supervision. The fact is that the State-by-State system of insurance regulation is the last vestige of 19th Century regulation. It is time to move into the 20th Century.

We would have you implement those recommendations—we would not—I would not contend that the implementation of those regulations would have prevented this current crisis entirely. But I do believe they would have helped regulators and the financial services industry to better and much earlier appreciate the market developments, and would have significantly reduced the scope and the severity of the crisis.

We do recommend, Mr. Chairman, three additional actions to take in the near term.

First, is fair value accounting. We advocate the use of a clear-minded system to determine the true value of assets in distressed and illiquid markets. The current application of fair value accounting is neither clear-minded nor fair. It is causing significant damage to individual institutions, but way more importantly, to the economy as a whole. The SEC and the Public Company Accounting Oversight Board has the authority to act. We urge them to provide auditors the flexibility in the application to apply fair value accounting.

Second, credit default swaps. We think that the first step is to—the first step will lead to regulation. We think the first step is to establish a clearinghouse for credit default swaps. We do think it requires a Federal regulator. We recommend either the CFTC or the Federal Reserve.

And then, third, is mortgage interest rates, Mr. Chairman. We believe that at this point this sort of mystical thing in London called the LIBOR has declined 6 days in a row—that is some kind of a record—to lead us out of the crisis, but it has not led to a reduction of mortgage interest rates. And until that happens, the economy will continue to be in jeopardy and getting worse. So if mortgage rates do not fall, then we urge Congress, the Treasury, and the Federal regulatory agencies to consider additional appropriate actions.

Lastly, Mr. Chairman, we do believe that sitting here on October the 21st, it is not clear at this point whether an additional fiscal stimulus should be adopted. But Congress should consider that if in the next few weeks the measures that have already been taken do not result in the beginning of a recovery, then we think the Congress should consider a stimulus package. That stimulus package, in our view, should have 3 points: Housing; job creation; and capital investment.

Mr. Chairman, we urge neither more regulation nor less regulation, but better, more effective regulation. Thank you.

[The prepared statement of Mr. Bartlett can be found on page 106 of the appendix]

Mr. WATT. [presiding] I thank the gentleman for his testimony. Mr. Yingling.

STATEMENT OF EDWARD YINGLING, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN BANKERS ASSOCIATION (ABA)

Mr. YINGLING. Thank you for the opportunity to present the views of the ABA on regulatory reform.

Mr. WATT. I am not sure your microphone is on.

Mr. BACHUS. And pull your microphone a lot closer.

Mr. YINGLING. Thank you for the opportunity to present the views of the ABA on regulatory reform. Clearly, changes are needed. The recent turmoil needs to be addressed through better supervision and regulation in parts of our financial services industry. The biggest failures of the current system have not been in the regulated banking system, but in the unregulated or weakly regulated sectors.

Indeed, while the system for regulating banks has been strained in recent months, it has shown resilience. In spite of the difficulties of this weak economy, I want to assure you that the vast majority of banks continue to be strongly capitalized, and are opening their doors every day to meet the credit and savings needs of their customers. As the chairman has noted many times, it has been the unregulated and less regulated firms that have created problems.

Given this, there has been a logical move to begin applying more bank-like regulation to the less regulated parts of the financial system. For example, when certain securities firms were granted access to the discount window, they were subjected to bank-like leverage and capital requirements. The marketplace has also pointed toward the banking model. The biggest example, of course, is the fact that Goldman Sachs and Morgan Stanley have moved to the Federal Reserve for holding company regulation. Ironically, while both the regulatory model and the business model moved toward traditional banking, bankers themselves are extremely worried that the regulatory and accounting policies could make traditional banking unworkable. Time after time, bankers have seen regulatory changes aimed at others result in massive new regulations for banks. Now, thousands of banks of all sizes are afraid that their already crushing regulatory burdens will increase dramatically by regulations aimed at less-regulated companies.

We appreciate the sensitivity of this committee and the leadership of this committee toward this issue of regulatory burden. As you contemplate changes in regulation to address critical gaps, ABA urges you to ask this simple question: How will this change impact those thousands of banks that are making the loans needed to get our economy moving again?

There are gaps in the current regulatory structure. First, although the Federal Reserve generally looks over the entire economy, it does not have explicit authority to look for problems and take action to address them. A systemic oversight regulator is clearly needed.

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

Finally, I wish to emphasize the critical importance of accounting policy. It is now clear that accounting standards are not only measurements designed for accurate reporting; they also have a profound impact on the financial system. So profound that they must now be part of any systemic risk calculation.

Today, accounting standards are made with little accountability to anyone outside the Financial Accounting Standards Board. No systemic regulator can do its job if it cannot have input into accounting standards, standards that have the potential to undermine any action from a systemic regulator. The Congress cannot address regulatory reform in a comprehensive fashion if it does not include accounting policymaking.

ABA therefore calls on Congress to establish an accounting oversight board, chaired by the chairman of the systemic regulator. The SEC Chairman could also sit on this board. The board could still delegate basic accounting standards-making to a private sector body, but the oversight process would be more formal, transparent, and robust. I believe this approach would accomplish the goal that the chairman mentioned a few minutes ago in his comments about separating mark to market from the consequences of mark to market.

And I appreciate your recent letter, Congressman Bachus, on this subject. That is a good goal. But I don't think that that goal can be accomplished if you have the current regulatory situation on accounting. Clearly, it is time to make changes in the financial regulatory structure. We look forward to working with Congress to address needed changes in a timely fashion, while maintaining the critical role of our Nation's banks. Thank you.

[The prepared statement of Mr. Yingling can be found on page 177 of the appendix.]

Mr. WATT. Thank you, Mr. Yingling.

Mr. Ryan.

STATEMENT OF T. TIMOTHY RYAN, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. RYAN. Chairman Watt, Ranking Member Bachus, and members of the committee—

Mr. BACHUS. Tim, pull that microphone a lot closer to you.

Mr. RYAN. Thank you. My name is Tim Ryan, and I am president of the Securities Industry and Financial Markets Association. I want to thank the committee for holding this hearing. It is a good time to do this. It is an important subject. I have a few brief remarks. I would like to have my full testimony entered into the record.

Mr. WATT. Without objection, the full text of all testimony will be put into the record.

Mr. RYAN. I am speaking on behalf of the Securities and Financial Markets today, but from 1990 to 1993, I was the Director of OTS. I also was one of the principal managers of the savings and loan cleanup. And from 1993 until April of this year, I was a senior executive at J.P. Morgan. So I would like to have my comments here reflect that background.

As you all know, the debt and equity markets across the globe have experienced serious dislocations in the last few months. Congress has aggressively responded to this by passing the Emergency Economic Stabilization Act, and granted the Treasury Department extraordinary responsibility to promote the confidence in the financial system. We fervently hope that the steps being taken will unfreeze the credit markets and restore calm to the equity markets.

Serious weaknesses, however, exist in our current regulatory model for financial services. And without reform, we risk repeating today's serious dislocation.

I commend this committee for beginning the process of reexamining our regulatory structure, with a view toward effective and meaningful improvements. We in the securities industry and financial markets stand ready to be a constructive voice in this critical, important public policy dialogue.

I have just a few specific comments on recommendations. One, which has been really a part of the comments all morning here, the need for a financial market stability regulator. As you know, our Nation's financial regulatory structure dates back to the Depression. That regulatory structure assumed, and even mandated to some extent, a financial system where commercial banks, broker dealers, and insurance companies engaged in separate businesses, offered separate products, largely within local and domestic borders.

Financial institutions no longer operate in single product or business silo or in purely domestic or local markets. Instead, they compete across many lines of business and in many markets that are largely global.

The financial regulatory structure remains siloed at both the State and Federal levels. No single regulator currently has access to sufficient information or the practical and legal tools and authority necessary to protect the financial system as a whole against systemic risk. Thus, we believe Congress should consider the need for a financial markets stability regulator that has access to information about financial institutions of all kinds that may be systemically important, including banks, broker dealers, insurance companies, hedge funds, private equity funds, and others.

This regulator should have the authority to use the information it gathers to determine which financial institutions actually are systemically important, meaning that would likely have serious adverse effects on economic conditions or the financial stability or other entities that were allowed to fail. We believe this is a relatively small number of financial institutions.

We think it is important that a stability regulator have information gathered through coordination with other regulators to avoid duplication of oversight and unnecessary regulatory burdens and provide confidentiality.

If Congress takes the approach of creating a markets stability regulator, it would be important to ensure that it not become an additional layer of regulation. Rather, Congress should consider the stability regulator in the context of the overall streamlining of financial regulatory system.

Second, additional steps are necessary to improve the efficiency and effectiveness of regulation. In general, financial services regulation has not kept up withinnovation or risk. Modernizing financial regulation should be a priority for regulatory reform by Congress. In general, financial regulation should encourage institutions to behave prudently, and incentivize them to implement robust risk management programs.

We also believe Congress should consider how financial regulation can be streamlined to be more effective. Duplicative Federal and State regulation is one area of review. Another is the separate regulation of securities and futures. We believe that the United States should merge the SEC and the CFTC in the interests of regulatory efficiency. Combining their jurisdiction would be consistent with the approach taken in other financial markets around the world.

Congress should also consider merging the Office of Thrift Supervision into the Office of the Comptroller of the Currency in order to achieve greater efficiency in the operation of Federal bank regulatory agencies.

One comment on structured products and derivatives: Innovation has generated many new financial products in recent decades that have the basic purpose of managing risk. For example, over the last 2 years alone, the credit default swap market has grown exponentially. CDSs are an important tool for managing credit risk, but they also increase systemic risk if key counterparties fail to manage their own risk exposures properly.

SIFMA recognizes the risk inherent in this market and will continue to work closely with ISDA, with the Futures Industry Association and with other stakeholders in an effort to create a clearing facility for CDS that will reduce operational and counterparty risk.

Mr. WATT. Mr. Ryan, can I encourage you to wrap up as soon as you can?

Mr. RYAN. Thank you, Mr. Chairman. I can wrap up right now. I am ready for your questions.

[The prepared statement of Mr. Ryan can be found on page 130 of the appendix.]

Mr. WATT. Thank you for your testimony.

I understand that Mr. Washburn is from the ranking member's congressional district, so I will recognize him for a brief introduction.

Mr. BACHUS. Thank you, Mr. Chairman.

Mike Washburn, his wife Marian, and his daughter Allie, are constituents of mine. In fact, his 12-year-old daughter Allie and about 1,000 other folks have announced their intention to run against me if I do not get my act together in the next election. He is the CEO of Red Mountain Bank, which is a very progressive community bank, with three locations in Birmingham and one in Tennessee. Far more importantly, he is on several ICBA boards.

His bank has received a prestigious national award for their community service, and it has also received 3 awards over the past 3 years as one of the best places to work in Alabama. So it is a good place to work. It is a successful bank.

They have avoided the problems that bring us here together today. That is why I think there ought to be a representative from Main Street here, and I think he is very capable in that regard.

So welcome to Washington, Mike. I look forward to some Main Street wisdom.

Mr. WATT. Mr. Washburn, you are recognized.

STATEMENT OF MICHAEL R. WASHBURN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, RED MOUNTAIN BANK, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA (ICBA)

Mr. WASHBURN. Thank you, Congressman. You took my first paragraph away.

My name is Mike Washburn. I am here from Red Mountain Bank; I am president and CEO of that bank. We are a $351 million community bank in Hoover, Alabama. I am here to testify today on behalf of the Independent Community Bankers of America. I appreciate the opportunity to share the views of our Nation's community banks on the issue of financial restructuring and reform.

Even though we are in the midst of very uncertain financial times, and there are many signs that we are headed for a recession, I am pleased to report that the community banking industry is sound. Community banks are strong. We are commonsense, small-business people who have stayed the course with sound underwriting that has worked well for us for many years. We have not participated in the practices that have caused the current crisis, but our doors are open to helping resolve it through prudent lending and restructuring.

As we examine the roots of the current problems, one thing stands out: Our financial system has become too concentrated. As a result of the Federal Reserve and Treasury action, the four largest banking companies in the United States today now control more than 40 percent of the Nation's deposits and more than 50 percent of the Nation's assets. This is simply overwhelming. Congress should seriously consider whether it is prudent to put so much economic power and wealth into the hands of so few.

Our current system of banking regulation has served this Nation well for decades. It should not be suddenly scrapped in the zeal for reform.

Perhaps the most important point I would like to make to you today is the importance of deliberation and contemplation. Government and the private sector need to work together to get this right. We would like to make the following suggestions:

Number 1: Preserve the system of multiple Federal regulators who provide checks and balances and who promote best practices among these agencies.

Number 2: Protect the dual banking system, which ensures community banks have a choice of charters and of supervisory authority.

Number 3: Address the inequity between the uninsured depositors at too-big-to-fail banks, which have 100 percent deposit protection, versus uninsured depositors at the too-small-to-save banks that could lose money, giving the too-big-to-fail banks a tremendous competitive advantage in attracting deposits.

Number 4: Maintain the 10 percent deposit cap. There is a dangerous overconcentration of financial resources in too few hands.

Number 5: Preserve the thrift charter and its regulator, the OTS.

Number 6: Maintain GSEs in a viable manner to provide valuable liquidity and a secondary market outlet for mortgage loans.

Number 7: Maintain the separation of banking and commerce and close the ILC loophole. Think how much worse this crisis would have been if the regulators had to unwind commercial affiliates as well as the financial firms.

We also believe Congress should consider the following:

Number 1: Unregulated institutions must be subject to Federal supervision. Like banks, these firms should pay for this supervision to reduce the risk of future failure.

Number 2: Systemic risk institutions should be reduced in size. Allowing four companies to control the bulk of our Nation's financial resources invites future disasters. These huge firms should be either split up or be required to divest assets so they no longer pose a systemic risk.

Number 3: There should be a tiered regulatory system that subjects large, complex institutions to a more thorough regulatory system, and they should pay a risk premium for the possible future hazard they pose to taxpayers.

Number 4: Finally, mark-to-market and fair value accounting rules should be suspended.

Mr. Chairman and members of the committee, thank you for inviting ICBA to present our views. Red Mountain Bank and the other 8,000 community banks in this country look forward to working with you as you address the regulatory and supervisory issues facing the financial services industry today.

Thank you.

[The prepared statement of Mr. Washburn can be found on page 168 of the appendix.]

Mr. WATT. Thank you.

Thank you to all of the witnesses for their testimony.

I believe Mrs. McCarthy is the first to be recognized in this round.

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman. Again, thank you for your testimony.

You know, when this all started, the first thing that came to my head was Enron. One of the things I was thinking about with Enron was, where is the moral guide in our financial system nowadays? I happen to think that an awful lot of innocent people are community bankers, are independent bankers, are credit union guys. They did not make any of these loans, yet they are still out there trying to help inside the community.

I know there was a story going back a while ago that one of the larger financial institutions on Wall Street had been told by their risk management guy that they were overloaded and that they should stop buying an awful lot of these pieces of commercial paper out there. He was fired. He did go to another large company that actually took his advice, and that was one of the larger companies that came out of this risk free.

We cannot legislate morality. Whether it was banking, or whether it was Wall Street, they have lost their way. Reputation on Wall Street was the most important thing, and that is what their customers counted on. We cannot do that. That has to come from within the system.

I guess what I need to know is, what are the lessons that we can learn from other countries? They got involved. They bought our paper. Everybody wanted to be part of that bubble. Have they done anything that we have done differently where we could look to them to see if there are some sort of regulations? They always complained about our having too many regulations. Now they are saying that we should actually be more regulated. So is there a balance in there? That is going to be the biggest problem, as far as this committee goes, in trying to find a balance. I do not think there is anybody here who really wants to overregulate. We want the system to run smoothly.

I would look forward to hearing any of your comments on that.

Mr. BARTLETT. Congresswoman, there is one lesson that we have studied a lot in the last 3 years from Europe and from FSA, the Financial Supervisory Authority, and that was to use guiding principles or principles for regulation in order to write your regulations. This does not eliminate regulations. The regulations are still there, but it is to create some uniform principles.

When we looked at the roundtable, it is like the weather in Texas. Everybody wants to complain about it, but nobody wants to do anything about it. So everybody wants to talk about principles, and nobody wants to write them down. We wrote them down, and I will enter them into the record.

Our conclusion was that there should be six, by statute, that this Congress should adopt as the guiding principles for regulations. They would include fair treatment for customers, stable and secure financial markets, competitive and innovative financial markets, proportionate risk-based regulation, prudential supervision, and responsible and accountable management.

I would offer that had those been in place for the recent round prior to the crisis, things would have been a lot different and a lot better.

Mr. YINGLING. I am not sure every foreign country has done all that well in terms of their regulation, but one thing we really do need and that, I think, there is a consensus on here is that we need an oversight regulator who really looks over the economy and who looks at gaps and who looks at trends.

I must say that about a year ago, I asked our economics department to give me the information on what had happened with some of these mortgages, and they brought me some charts that really made me gasp. These were charts about no-down-payment loans and how they had grown in 2004 and in 2005 and in 2006. That graph went like that. How you could have graphs like that and not have somebody in our government say, "Wait a minute. We have to really look into this very hard," is somewhat beyond me, because I gasped. I said, "How could this be?"

I think the problem is that nobody has really been assigned to do that. In some ways, the Fed was supposed to do it, but we have not assigned anybody in our government to look at potentially big problems. Why didn't we have somebody looking at the growth of these SIVs? Why didn't we have somebody look at and see the growth of the securitizations of these mortgage products? It fell between the gaps.

So I think one thing we need is a systemic overview regulator who has the explicit role of saying, "I am going to look for big problems." Any time you have a chart that goes like that, you had better look at it. We do not. It falls between the gaps.

The CHAIRMAN. The gentleman from Michigan.

Mr. MCCOTTER. Thank you, Mr. Chairman. Thank you for holding this hearing.

We heard from the previous panel. From yourselves, I gather that in many ways this was not a failure of deregulation or a philosophy of deregulation. It seems that in many ways the entrepreneurial spirit of the free market had transcended regulation, and that it was a failure then to intelligently, proactively and accountably act as a government to step in, in instances of a failure of self-government on the part of market participants.

What I would be very curious to hear, as we enter into this initial discussion of where we are going to head, is when you speak of principles, to me the fundamental principle undergirding a free market economy is the principle of personal responsibility and that appropriate regulation creates a framework in which people can self-govern through the concept of personal responsibility with guidelines that ensure that human nature does not always exceed the better angels of our nature.

So, as we move forward, I would like to hear from the panelists as to what specifically we can try to do to encourage personal responsibility within a regulatory environment so that we will wind up with a proper framework as opposed to a governmental dictation to the market, which could have a very deleterious effect on the future prosperity of Americans.

Mr. RYAN. I would like to address your comments and the question posed previously.

As you can see from our opening comments—and I think we are all pretty consistent here—the financial markets are very global. We have considerable concentration globally in financial services, and they are interconnected. We have no real regulatory structure globally to address those major institutions, so that is work that is critical here. It is critical that it needs to be replicated without massive overlap in the European community and probably in other major countries, developed countries.

We have many financial institutions that are much smaller than the type I am talking about that are subject to the financial market stability regulator. There it is easier to have personal responsibility within boards and within management. As you get into some of these larger institutions, clearly people take their jobs seriously. They work actively to manage risk, to manage their people. At times we need an oversight, and that is what the market stability regulator could do, integrate a lot of that information; provide integrated, aggregated information to the people who run these institutions so they can manage the risks.

Mr. McCOTTER. On that point, I think it is a very accurate point, because one of the other problems that, I think, has become apparent is that it was a failure of government reform, a failure to reform the United States Government to the point where you could have intelligent, proactive, and accountable regulators in place that could try to keep up with the market in instances where there were failures to self-govern, because, as you know, even where there are some misdeeds amongst many good deeds, those some misdeeds can cause a lot of problems.

You also referenced something that I find fascinating. Secretary Paulson also mentioned it previously, although not in front of this committee. He talked about how now the interdependence amongst American financial institutions was originally thought to be a guard against the very type of meltdown that we saw; that if we had linked them all together, and that if one were to fail, the new web of financial institutions would help support the overarching framework of the financial services sector. Yet the exact opposite has happened. Has that not been replicated on the global scale as you seem to indicate?

So then what we have to look at is not only an internal reform of the United States Government to get more intelligent, proactive and accountable, but we will also have to start looking at our international institutions to guarantee that the interconnectivity between global financial institutions does not lead to what we seem to be on the brink of, which is a continued meltdown based upon some bad actors dragging everyone down with them on top of innocent people.

Thank you.

The CHAIRMAN. Any comments, gentlemen?

I thank the gentleman.

We now have the gentleman from Massachusetts, Mr. Lynch.

Mr. LYNCH. Thank you, Mr. Chairman.

I thank the panel for their willingness to help the committee with its work.

At a very basic level, I think there are a couple of things we have to admit to in going into this whole idea of reforming our regulatory system. One is that we cannot and should not try to prevent every single failure. That is not the purpose of our regulatory framework. On the other hand, I think it is enormously important that we should devise a system that allows investors and market participants to have accurate and timely information in order to defend themselves and in order to make prudent and well-informed decisions.

There are a couple of examples out here that we have seen in this whole crisis. I want to point to one which is really illustrated best in an article by Gretchen Morgenson of the New York Times a while back. She was talking about Bear Stearns. The article is on Bear Stearns. She was talking about—this was at the very end—on their way down, based on their annual report, they reported that they had $46 billion in mortgages and in mortgage-backed securities and in complex derivatives based on mortgages; $29 billion of them were valued—and this is a quote—"using computer models derived from or supported by some kind of observable market data."

Then she goes on to say that the value of the remaining $17 billion, according to Bear Stearns, is estimated based on "internally developed models or methodologies, utilizing significant inputs that are generally less readily observable." In other words—and these are her words—"your guess is as good as mine."

We have another example in the Merrill Lynch situation where E. Stanley O'Neal, the CEO, went out on October 5th and said that the company had $4.5 billion in writedowns. On October 30th, 3 weeks later, he came out and said that they had $7.9 billion in writedowns. Then in November, he increased the amount to $11 billion.

The bottom line here is that neither of these companies knew what was going on internally. They did not have internal transparency. Part of that reason is the complexity of these instruments, and with a system based on trust, it is extremely important. If we are ever going to get back to a system of normalcy, we have to have that type of transparency.

Mr. Ryan, you mentioned earlier the clearinghouse and how we might deal with derivatives and how we might vet these things or have a clearinghouse to quantify the value of these. Is it not the case that we are going to have to bring these instruments that are outside the regulatory process into a tighter regulatory framework?

Mr. RYAN. The answer is yes.

One comment: Clearly, from our perspective, financial engineering was taken to a level of complexity that was unsustainable. We know that 2 years from now, you are not going to have hearings where you are talking about CDOs and some of the other things that Ed talked about—SIVs and different off-balance-sheet vehicles.

Clearly, the industry and the country and, in fact, the financial market participants around the globe have seen that the complexity is just too much, so we are all focused on what we can do that makes sense. We are all focused on the critical element in financial markets, which is confidence. Right now people lack confidence. That is what is reflected in the volatility in the markets, and we need to fix that. So we are very, very focused globally within this industry on fixing it.

Mr. LYNCH. I am happy to hear you say that. I am just concerned that when this urgency goes away, that the folks over at MIT, whom I dearly love, will go back to designing these very complex models, and that we will be back into this same mess again. So I am hoping that we might fix this once and for all.

I do not know if anyone else wishes to comment.

Mr. YINGLING. I happen to think all regulators and all Wall Street bankers ought to watch "Jurassic Park," because it is kind of the same thing, a theory about how everything will work, but the reality is the animals will figure out a way around it.

Mr. RYAN. I spent a lot of time in this hearing room from 1989 to 1993 because we were closing seven institutions a week at that time, and we had all kinds of problems. So I certainly did not intend to come back here 15 or 16 years later. We are talking about different instruments and different problems, but, also, in the financial sector.

So what I have learned is that things do repeat themselves. They are a little bit different. The most important thing is, because regulators are looking in rear-view mirrors principally, we need to set up a structure that actually can look forward and that can have the ability to understand what we are actually doing on a global basis. We need to have the right people. We need to have enough people, and we need to pay them enough so they can really maintain, keep, and attract the right people.

Mr. LYNCH. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

The gentlewoman from Illinois.

Mrs. BIGGERT. Thank you, Mr. Chairman.

I would like to direct my first question to Mr. Washburn.

I have been out and about in my district, talking to my local banks and credit unions. What they have been saying is that they are doing okay, that their mortgages were kept in house, and that they do not seem to have the lack of liquidity as much as the larger banks do.

So I was wondering, Secretary Paulson is pushing a program under the capital purchase program that will capitalize banks, not just those in trouble, and that they should be included in this program. Would you agree with that for the smaller banks?

Mr. WASHBURN. I would.

In speaking for ICBA, there has been a lot of interest among our membership, again, of 8,000 banks participating. And speaking specifically about Red Mountain Bank, we would be interested in participating in the program. Capital is king, and we are in a great market. We are experiencing a tremendous loan demand because of what is going on around us. If we had additional capital to grow, it would be a great thing for our bank, for our economy, for job creation, and for all of the things that go along with that. So, indeed, we would be willing to participate, and we would be very excited about the possibility.

Mrs. BIGGERT. In your testimony, you advocated that there be a tiered regulatory system with less stringent and less intrusive regulation of community banks.

Do you think that the banks might then be willing to take more risk if they do not have the same regulations as do the larger banks?

Mr. WASHBURN. Absolutely not. Community banks have been around forever, and we operate by a very simple business model. We lend money to people who pay us back. It is very simple. It has worked for years. We continue to want to do that going forward, so I do not see that changing whatever changes here.

Mrs. BIGGERT. Do you think that one of the problems with the financial institutions in getting into this securitization was that they did not keep part of the assets within their own institution?

Mr. WASHBURN. I agree. That is so true.

You talk about covered bonds and things you see and you read about today. If those assets had remained on the balance sheet, and you had had responsibility and personal responsibility for those, and if it had been your money invested in your bank, it would be a new day for not only the people inside the bank, but for the shareholders and for the regulators as well.

Mrs. BIGGERT. Thank you.

Then the other thing we have heard is that the engine will start up again once the banks are willing to loan to each other. Is that a problem in the community banks?

Mr. WASHBURN. No, ma'am.

Mrs. BIGGERT. Maybe I will ask Mr. Yingling.

Is that the big problem, this credit freeze between banks?

Mr. YINGLING. Well, it is really a problem with the larger banks in the international markets. As Mr. Washburn said, it is not really a problem with community banks. The great majority of community banks are in solid shape and are willing to lend. This new program can have a positive impact.

One thing we have to watch is how many strings are attached, because these are banks that can do just fine by themselves, but they need capital to support growth in lending, and the capital markets to community banks right now are not functioning very well. So you could have a situation where a bank will take some of this capital for a very short period of time, and then when the capital markets open, they will replace it with private capital.

Mrs. BIGGERT. Okay. I asked that question earlier about the Secretary's Blueprint. Do you agree with changing the regulators from the functional to the other types of regulators that he has proposed?

Mr. YINGLING. By and large, we have found some positive things in the Blueprint. We did not care for it. For one thing, we found that, in the end, the structure was more complicated for an individual bank than it had been to start with.

Mrs. BIGGERT. Do you think that would help, though, the systemic risk problem that we seem to be having with the regulator?

Mr. YINGLING. It was not covered particularly in the Blueprint, but as I testified, I do think there is a real need for a regulator who looks over the economy. Now, that may be different than the regulator who actually regulates day-to-day, but we had not had somebody looking over the economy and identifying these incredible types of growth and these bubbles, such as the mortgage bubble and other bubbles. So we do need a regulator who has the charter to look across the economy and to identify problems before they occur.

Mrs. BIGGERT. Thank you. I yield back.

The CHAIRMAN. The gentleman from Georgia.

Mr. SCOTT. Thank you, Mr. Chairman.

It is good to have you all here. As bankers, you are right in the catbird's seat. You represent about 95 percent of the entire financial industry's assets; that comes to about $13 trillion. That is everything, so it is critical that you stay healthy.

As we go forward with this restructuring for reform and for regulatory reform, there are two types: There is the unregulated; and then there is the regulated part of your industry. We have to look at it in a way in which we come up with a delicate balance. Nowhere is the vulnerabilities. I talked earlier in my opening statement that we must zero in very quickly in the vulnerabilities, and that there is no greater vulnerability than what caused this problem, and that is bad mortgages and default.

I know one thing: If we follow the scenario of what got us into this problem, and if we get the urgency quickly to resolve it, we are on our way, because the American people want some real solutions, and that is this: Home foreclosures and these bad deals that were made, first of all, we have mortgage brokers and loan originators who go in and make these loans based upon high risk because that is the way they are compensated. Somebody has to do something about that. Then they take these loans, and they securitize them. Once they are securitized, it immediately disconnects the loan servicer and the loan originator from the borrower. Then these security packages are packaged, and they are sold all around the place. So people are just in there; they make their money; they cut it up, sell it; and they are out of there. Then these mortgages are sold and packaged all around the world. That is how we got into this. So we have to move forthrightly in that respect, and I would like to get your comments on that.

Secondly, I believe that we have to put an infusion of capital into helping homeowners stay in their homes. Now, Chairman Frank was kind enough when we were on the Floor with the $700 billion bailout to allow us to address that issue. One of the things that we need to do is to put in some capitalization. We tried to get 1 to 2 percent of the $700 billion or to direct the Secretary to make sure we had that available. We do not have any incentives in here for the lenders and for the loan servicers to come in and to restructure these loans on a sustainable basis. We have an economic stimulus package coming. We could not get it in there because, as the chairman said, we would have to send the bill back to the Senate. Chairman Frank and I have instructed the Treasury Secretary to move in this regard, and we realize that there has to be some money set aside.

I have talked with Barack Obama about it. He certainly was for this going forward, as you will recall, as a modified, different type. At least Senator McCain also addressed this issue. We need some money. Just as surely as we got it for Wall Street, we need some money set aside here so that we will be able to have money to help homeowners stay in their homes and to restructure these loans and to put some incentives in there for lenders to go and to restructure their homes.

The CHAIRMAN. If the gentleman wants answers to the questions, there is only about 1 minute left.

Mr. SCOTT. I would. We have the economic stimulus coming up. We might be able to address it here. Please do so. Thank you.

Mr. RYAN. May I give an answer on securitization, please?

Mr. SCOTT. Yes.

Mr. RYAN. Thank you.

Just to put this in perspective, globally, and by our estimate in 2007, about $2.5 trillion of consumer assets were securitized and distributed. This year, in 2008, we will be down very significantly at less than $1 trillion, probably at about $800 billion. This is principally mortgage, but also credit card, auto, and student loans.

Without the securitization process that has developed over the last 20 years, many, many citizens would not have had access to this consumer financing. The financial system in the United States, which we all know well, does not have the capacity from a capital standpoint to support the consumer finance that I have just noted here without securitization.

Now, we know we have had some issues with securitization. I am sure this committee has talked about some of the things that need to be done. We have been working very, very hard at reforming the credit rating agency process, at disclosure and transparency on underlying documentation and at valuations for securities. We are highly confident that we can roll out a process here that would make a lot of sense and that would still afford people the opportunity to pay for their homes, to buy cars, and to use credit cards.

The CHAIRMAN. One quick answer if anybody has any other comment.

Mr. YINGLING. I just want to say your analysis of the cause of the problems was exactly right. One of the things that is not talked about much is when the unregulated side did these things—and this happens all the time—they ended up blowing up the regulated side. So this has had a very negative effect on good banks that did not do any of this.

I would also say that it just seems to me that some part of the stimulus package ought to be devoted to what caused the problem. That is housing—keeping people in their houses and helping some of those homes be taken, perhaps, by entrepreneurs who would turn them into rental housing.

The CHAIRMAN. The gentleman from Texas.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

On one of the things I agree with Mr. Yingling and with Mr. Washburn, and it is that we need to make sure that we do not overreach and impact those financial institutions that did not do that. I kind of liken that to little Johnny misbehaved in class, and the whole class had to stay after school.

What we have in our banking system today are our community banks. Some of them are small. Some of them are medium-sized. Some of them are large community banks. Then we have these very large banking financial institutions. There is going to be a lot of discussion over the next few months and years, probably in this committee, on systemic risk and on the size of an institution and on how you manage that risk.

With a broad range of financial institutions, how do we develop a new regulatory pattern or institution that can regulate such a broad range? Because one of the things we hear folks say is that we need one regulator for, for example, the banking industry or that we need two regulators.

Can one regulator do that? What would that new structure look like, if we were to change that structure, that could regulate such a wide variety of institutions?

Mr. WASHBURN. I cannot imagine one regulator regulating the entire banking system as we know it. That is one reason we are calling for the divestiture of those larger institutions into a more manageable size. I think that is critical. We still maintain and we still believe that we need different regulatory bodies. There are two types of charters available to us. This creates some healthy competition among the regulators. As long as they maintain contact in interagency decisions, they will all be governed consistently across the board.

Mr. YINGLING. I would agree with that. In the dual banking system, the diversity of charters has been critical. It is one area where we differ from some other countries.

One of the advantages of it is that there is much more lending and capital available to small businesses and to entrepreneurs in this country because we have such a diverse system.

I think another thing—and this committee has worked hard on it—is to recognize that when you pass rules designed to solve a problem, that they quite often apply most heavily to your analogy that did not cause the problem. One of the really big problems for community banks, and it may be the biggest problem in competing today, is just the huge regulatory burden. There are great economies of scale in dealing with these regulations, and the small banks just cannot deal with that.

Mr. BARTLETT. Congressman, I might add that you are not going to get down to one regulator, nor should you, but there should be fewer regulators than there are now. More importantly, the system of regulation should be coordinated between one another. There are literally hundreds of regulators for financial services, and it is the gaps that cause the problem.

One other admonition: I would hope that the committee and the Congress and the industry do not sort of fall into the traditional fights of large versus small. It is not large versus small; it is a continuum of size, just like every other industry. Nor should they pit one sector against another, the traditional thrift versus bank, insurance versus bank versus securities dealers.

The fact is that it is an integrated financial services system that needs to be regulated as an integrated financial services system for safety, for soundness, for systemic regulation, and for business conduct. Therein lies the answer.

Mr. NEUGEBAUER. One of the issues that keeps coming up is "too big to fail." So the question is: When we look at the factors of systemic risk, if size is a piece of it—and we heard Mr. Washburn say that he thinks that some of these entities are too large, if you do not break up these larger entities, is there a regulatory environment where you can manage systemic risk from the safety and soundness side rather than having to worry about the size of that institution?

Mr. BARTLETT. Well, first, I would just submit that there is no such thing as "too big to fail" from the perspective of the shareholders. There are shareholders all over America who have failed. The Federal Reserve and others have concluded, I think appropriately, that there is a certain size where the systemic risk to hundreds or to thousands of other companies and individuals is so great that allowing those assets to simply stop is worse for everyone, and so the assets and the liabilities go somewhere else, but the institution failed.

Secondly, I think that it is not so much the size as it is the regulation, to make sure that it is regulated for the gaps so that each regulator talks to one another and coordinates with one another. I do not think it is the size overall. I think it is what the institutions do, not how large they are.

The CHAIRMAN. Mr. Ryan, do you want to add something quickly?

Mr. RYAN. My only comment here is that the issue before the globe, really, right now is not really "too big to fail." It is the issue of interconnectedness and, when we see an interconnected entity that has problems, what the governments need to do about it. I think that is the major issue on the table going forward.

The CHAIRMAN. The other gentleman from Texas.

Mr. GREEN. Thank you, Mr. Chairman.

Mr. Chairman, there are some things that the consumers are focusing on, and they are becoming more and more sophisticated. There are some things that they just cannot understand. They do not understand why a person with five homes can go into bankruptcy, where he can save four but cannot save his principal residence. They see something inherently unfair about a system that allows me to save my vacation home, but that will not allow me to save my residence. They do not really understand why there is something called a yield spread premium that allows the broker to qualify me for a loan at 5 percent, to accord me a loan at 8 percent, to get a lawful kickback, and to not have that made known to the consumer. They really do not understand how we can have naked short selling and not do something to try to curtail it. They do not understand how hedge funds that require sophisticated investors can have pension funds with money that belongs to pensioners who are not necessarily sophisticated investors. This is in the truest sense of what a sophisticated investor is, not based upon knowledge, but based upon capital as well as some degree of intellect. So the American public is starting to focus on these things, and they are becoming very concerned about them.

My question to members of the panel would be, do we need to do something about some of these things? The bankruptcy law that allows for the vacation home to be saved in bankruptcy, but for my principal place of residence or for the consumer's principal place of residence not to be saved, is that law just fine as it is? If you think that it is just fine as it is, would you kindly raise your hand?

All right. Mr. Bartlett, let us start with you.

The CHAIRMAN. For the benefit of the reporter, I assume you got who raised their hands.

Mr. GREEN. Mr. Bartlett and Mr. Yingling.

The CHAIRMAN. I would just encourage Members to remember that the system of recordation was not made for pantomime.

Mr. GREEN. Thank you. I appreciate that, Mr. Chairman. You are a much better lawyer.

Let us just visit briefly—I think, Mr. Bartlett, you mentioned earlier that the next stimulus package should contain something with a reference to housing. What did you have in mind for housing?

Mr. BARTLETT. Congressman, it is very clear that it was housing that led us into the recession, and so I think the housing is going to be required to lead us out of the recession.

Mr. GREEN. Because my time is going to be very short, I am going to have to interrupt. Please forgive me. I do not mean to be rude, crude, and unrefined, but I have 5 minutes, and there is much more that I need to do. So let me ask you this: With reference to bankruptcy, what do you see as the impediment to allowing persons who only have one home to save their one home when they are in bankruptcy?

Mr. BARTLETT. We think that person should be able to save that home if you can remodify the mortgage so that they can pay it.

Mr. GREEN. That is what the bankruptcy laws do not permit. They do not permit the restructuring of the loan so that you can reduce principal and so that you can reduce interest. That is what the laws do not permit.

So are you saying that you would now allow this?

Mr. BARTLETT. We do allow that. We do it all the time.

Mr. GREEN. Would you allow the bankruptcy laws to be amended so that this can be done by a bankruptcy judge?

Mr. BARTLETT. Congressman, I suppose our disagreement would be that we do not agree that people should be required to go into bankruptcy in order to modify their mortgages.

Mr. GREEN. Well, it is when you go into bankruptcy. It is not because you want to, but it is because you have to, because it is your last resort, and because your home is all you have left, and you are trying to protect your last good chance to start all over again in life with a home. That is what we are talking about.

Should the bankruptcy laws allow a person to keep his home?

Mr. BARTLETT. Congressman, I suppose what I am trying to say is that we hope now the new Treasury proposal on a much faster pace is modifying mortgages and will be modifying mortgages without requiring people to go into bankruptcy.

Mr. GREEN. I understand. Those who do have to go are the folks we are talking about, not the ones we would hope would never get there. Some do go into bankruptcy. Why not have that person afforded the opportunity as the person who has two homes? Senator McCain said he had seven homes, I think, or eight, I am not sure how many; he can save six of those homes. The person in bankruptcy with only one has a problem. He cannot save that one under the current law.

Mr. BARTLETT. It is hard for a Texan to disagree with another Texan. We are trying to get to the same place.

Mr. GREEN. Well, we do it with a degree of love for each other. We are going to still be friends when this is all said and done, but some of us are concerned about the consumer who has to lose everything and who, maybe, should be afforded the opportunity to save his or her home.

The CHAIRMAN. Let Mr. Yingling finish.

Mr. YINGLING. Just quickly, it is a trade-off because, right now, the interest rate on that second home is higher because of the bankruptcy rules. So, if you make the first home like the second home, it may help some people now, but it means that, marginally, interest rates are going to be higher on everybody else who gets a first mortgage going forward. That is the trade-off that Congress has dealt with.

The CHAIRMAN. The gentleman from Missouri is yielding to the gentleman from Texas one of his minutes, I gather.

Mr. GREEN. Yes, sir.

My understanding is that same argument was made with reference to farm property, that the interest rates would go up on those farm loans. We find that, after a while, these things tend to find their own equilibrium in the economic order. At some point, the consumer ought to be given some preference in this process; $700 billion and we do not bail out the consumer? Something is wrong. People are not going to stand for it. I am telling you we have to focus on doing something for the consumer.

With regard to the yield spread premium, really fast, what would you do about the yield spread premium?

Mr. YINGLING. Well, I think it is something that needs to be looked at.

Mr. GREEN. We have looked at a lot of things. What do we do about it?

Mr. YINGLING. There are some ways in which it is justifiable, but it has clearly been abused. There is no doubt about it.

Mr. GREEN. What about putting pension funds into hedge funds where you are required to be a sophisticated investor?

Mr. YINGLING. Well, you would have to talk to the pension fund people. I think they would tell you that they have made some money on it. Clearly that is another issue that needs to be looked at.

The CHAIRMAN. We will go back now. The gentleman will get his 4 minutes after the gentleman from Ohio.

Mr. LATOURETTE. Thank you, Mr. Chairman.

To my friend from Texas, I would just share your pain and would indicate that when you have closed rules, nobody gets to make modifications to bills. You do not get cramdown. We do not get a repatriation of funds.

Mr. Chairman, I want to ask unanimous consent to enter into the record an October 15, 2008, letter from CUNA to balance out Mr. Kanjorski's NASCUS letter.

The CHAIRMAN. Yes, we have general leave.

Mr. LATOURETTE. Thank you so much.

Gentlemen, at the beginning of the hearing, I referenced two articles, one appearing over the weekend in the New York Times that dealt with a development down in Texas. In this morning's paper, in the Cleveland Plain Dealer, it talks a little bit about the same thing. The author of the Plain Dealer article is a guy named Phillip Morris.

You, Mr. Bartlett, and you, Mr. Yingling, at least have talked about the unregulated side dragging down the regulated side. I just want to sort of focus on that for a second. There was a fellow just indicted in Ohio for turning a place called Slavic Village, a beautiful place, into a wasteland. The fellow who has been indicted was a mortgage broker from Cleveland Heights.

Basically, the article indicates—and I am paraphrasing—that he could turn you into a real estate mogul on somebody else's dime. No credit, no problem. The guy would invent you some. No work history, no problem. He could create that, too. The example is a guy named Irvin Johnson, not the basketball player but another Irvin Johnson. He indicated that the FBI was sort of sniffing around because, between 2005 and 2006, he and his wife amassed nearly $2 million in residential property. By profession, he was a grass cutter who made no more than $10,000 a year, and his wife was a nurse's aide. So it clearly goes through that probably this guy should not have been qualified for the six mortgages that he had.

I think we would all agree that the unregulated side and the unscrupulous, in some cases, had willing victims, but his walk-off line is: The bankers who financed and who once greatly profited from the foreclosure epidemic remain in the shadows. I think what he is talking about is that the unregulated side may have originated the mortgages, but that the regulated side purchased the mortgages, and then they were securitized, as Mr. Ryan talks about.

Either Mr. Bartlett or Mr. Yingling, if you could respond to sort of that walk-off line. We all know of these fly-by-night groups that came in and that wrote mortgages they were not supposed to write on the basis of a commission, but then somebody bought them. Somebody bought the paper.

Mr. Bartlett.

Mr. BARTLETT. Congressman, you have it about right.

During the crisis of subprime, 50 percent of all of the subprime mortgages were originated by a totally unregulated mortgage lender. Fifty-eight percent total were sold by mortgage brokers, but it is actually worse than that because then the other 50 percent that were originated by regulated lenders, regardless of the nature of those loans, were mostly then sold to Wall Street, to a different set of regulators, either lightly regulated or not regulated at all, that were then packaged up into another set of unregulated mortgage pools, that were then brought back to mortgage insurance, which was regulated by 50 State regulators, and that were all sort of certified by credit rating agencies that were not regulated at all.

So, as to the system as a whole, you are right. Half of it originated was totally unregulated, but the rest of the system that was regulated was virtually unregulated at least with the gaps. So it is the system that needs to be reformed systemically.

Mr. LATOURETTE. I would say where some of us had a disappointment or a dissatisfaction with the Treasury Department's proposal is that is where the $700 billion is going, to the other lightly regulated side, which was packaging and then moving these mortgages. It was not the traditional banks, right?

Mr. BARTLETT. Well, Congressman, I would not concur. I think the $700 billion is going to a whole series of places to put capital back into the system, including buying these mortgages. When that happens, the first step is to put capital into the financial institutions overall, not merely into banks as the statute provides.

Mr. LATOURETTE. Let me just ask: Three of you mentioned mark to market. I asked the last panel about mark to market, and one fellow from Rochester said I was trying to go back to the 13th Century, I think.

Mark to market, I am told, is really having a tremendous impact on the ability of the community banks—all banks—to have the capital necessary to loan. I would just ask you each to make that observation. If mark to market is not it, what should we put in place of mark to market, or what follow-up should we have on the chairman and Mr. Bachus' idea of looking at the ancillary impact of mark to market?

Mr. Yingling.

Mr. YINGLING. Well, I think what the chairman said a little while earlier in the hearing makes a lot of sense. There are a lot of straw men in this debate. Nobody is talking about not disclosing everything.

When you have mark-to-market accounting in a dysfunctional market—and I will just give you an example, the Bank for International Settlements, which is the premier international regulatory body, did a study a month or so ago that said the top tier of mortgage securities, the safest part of the mortgage securities, was being undervalued by the index that was used as the base for mark to market, undervalued by 60 percent because that index is in a dysfunctional market. It is a very narrow index. It is an index that is based on dumping. It is an index that is run by bears, and that is what they said. So it may make sense to disclose that. What does not make sense is to have that drive issues relating to capital and to the ability of institutions to function.

So I do think you need to have a system in which you can have disclosures, but the impact of mark to market has to be dealt with.

The CHAIRMAN. We have to finish up here, Mr. Yingling.

Mr. YINGLING. Frankly, I think the current structure will not let you get there. I do not think the SEC's regulating FASB in the light way they have will let you get there. That is why we have put out a proposal that would have an oversight board, headed by the systemic regulator. I think that would help the chairman get to his proposal.

The CHAIRMAN. Thank you.

Now I have a request of the witnesses. Would all of you look around and see if you can find Joe Stiglitz's cell phone, which he left somewhere, and it is turned off? So, if you find his cell phone—

Mr. WASHBURN. What is his number?

The CHAIRMAN. Well, it is turned off. Nobody should sit at the witness table with his or her cell phone turned on.

The gentleman from Missouri has 4 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman.

Whenever we begin this discussion of regulation, it always creates ideological differences.

Mr. Yingling and Mr. Washburn, I am wondering, since someone here on our committee made a comment before the break that the CRA and minorities were responsible for the subprime mortgage debacle, I would like to find out from you, from the banking industry, do you believe that the CRA is a regulatory burden?

Mr. Yingling or Mr. Washburn.

The CHAIRMAN. I am sorry. Let us not have anybody standing in the way of the witnesses.

Mr. YINGLING. Well, I want to say that banks have no trouble with the philosophy of CRAs. Indeed, if you are going to be a good banker, you should be serving your communities.

Mr. CLEAVER. I am sorry. I hate to interrupt, because I think that is rude. Could you just answer the question, because I only have 4 minutes.

Mr. YINGLING. We do have some problems with the regulatory costs, but I have made a strong argument during these hearings that the root cause—and some of your colleagues have talked about it—was the unregulated part of the financial services industry in starting these loans, bypassing the regulated banking system and taking them to Wall Street. CRA applies to the regulated side. So I am sometimes inconsistent, but I try not to be inconsistent in a public hearing. So, having argued that it is unregulated that started it, it is hard to argue that the regulated part with CRA is a major cause of it.

Mr. CLEAVER. Mr. Washburn.

Mr. WASHBURN. I do not think it is a major problem. We live in a very regulated world. Being a commercial bank, it is part of the regulations that we understand and that we deal with weekly, daily and annually. So I do not see its being a major problem.

Mr. CLEAVER. Okay. So Congressman Green and I did not create this debacle, nor did our people?

Mr. YINGLING. Well, we have many community banks that are living with CRA, and they did not cause this problem.

Mr. CLEAVER. But do you understand the—you do understand. Thank you for your answers.

I guess the point I want to make is whenever we begin to speak about regulations it generates the rising of this ideological opposition. And in order to make points, then false information is shot across the country. It is refreshing that those of you who represent the banking industry are not involved in that.

I think it would be very healthy if you would—your associations would speak very openly and clearly about it because I knew that when I went to my town hall meeting Saturday that it would be just a matter of time before someone stood up and said the CRA and minorities caused this crisis. And I think when we talk about regulations, it is used as an opportunity to divide as opposed to trying to figure out ways in which we can operate our financial institutions better.

Thank you, Mr. Chairman.

The CHAIRMAN. Will the gentleman yield just briefly? I had the staff do a very thorough study, and at no point in the history of CRA is there any evidence that any covered institution was ordered to comply with CRA by engaging in credit default swaps. We are able to definitively say that.

The gentleman from New Jersey.

Mr. GARRETT. I thank the chairman and I thank you all here for your testimony. One of the things, obviously, that has led to the macro issue, the credit problem issue they are currently experiencing as indicated earlier, is the problems in the mortgage sector. I thought I would take a moment to discuss an alternative to our current mortgage securitization process, and I think one of your members mentioned it before, just very briefly, and that is covered bonds.

Covered bonds, as you know, have been used effectively in Europe for centuries and recently were introduced in the United States. Basically, they are debt instruments created from high-quality assets and they are held—and this important—on the bank's balance sheet and secured by a pool, and that is why it is called a covered pool of mortgages.

And so in contrast to mortgage securitization where loans are made and then sold off to investors, a covered bond is a debt instrument issued by the lending institutions to the investors. And this debt is then backed or covered by that pool of typically high-rated AAA mortgages, and they then act as the collateral for the investor in the case of a bank failure. This structure keeps the mortgages on a lending institution's balance sheet. And that also provides for greater accountability, if you will, as to the high underwriting standards. And they have the potential to aid and return liquidity to the mortgage marketplace we are in today through improved underwriting and accountability.

I will just say as an aside, I dropped in a bill, H.R. 6659, the Equal Treatment of Covered Bonds Act of 2008, and this legislation will clear up some of the ambiguities in the current law and codify several existing parameters of the market. It enshrines in the investment tool the law that will provide greater certainty, stability, and permanency for covered bonds.

In addition, the spreads would be narrower, which will encourage more institutions to enter into the covered bond marketplace. And it is a goal to provide an environment through its legislation in which the market would be able to flourish, as it used to be, and produce increased liquidity. So legislation covered bonds provide for a greater sense of legal security than ones through regulations.

And so, Mr. Ryan, I will throw that out to you. I know SIFMA announced at the end of July, in the summer, that it was creating a U.S. covered bonds traders committee, possible investors that would support the growth of covered bonds market in the United States and play an active role in fostering and strengthening this market.

I know that there have been a lot of other things going on as far as other proposals and recommendations that you have been talking on. But I would ask you, first of all, how is the committee going, what do you see for the future? And then I have another couple of questions.

Mr. RYAN. The committee is working, I would say, comprehensively in coming up with reasonable suggestions to the Congress and the Administration on changes that are necessary in the United States so that we can have a covered bond market similar to Europe. Our members in Europe are integrated into that program. So we are trying to take what we have learned in Europe and apply it to the United States.

We certainly appreciate the attention you paid to this issue because once we make our way through this crisis, we will need to find new tools for financing housing in the United States. This could be one of them.

Mr. GARRETT. One last question on this point is, do you see the benefit of doing this through the legislative process, to try to bring that homogeneity to it and also the structure to it and the stability to it, as opposed to a regulation approach?

Mr. RYAN. I think it probably will require some statutory changes and we will give those to you.

Mr. GARRETT. I appreciate that. Does anyone else on the panel need to—or not need to, but wish to address the issue of covered bonds? I see my time is just about up. If not, then I yield back to the chairman.

The CHAIRMAN. The gentlewoman from Illinois.

Ms. BEAN. Thank you, Mr. Chairman, and Ranking Member Bachus, for holding this important hearing today on something so many Americans are concerned about. They are rightfully concerned about their own and our Nation's economic futures and want to know that we are going to put in place the oversight and transparency to avoid this kind of situation ever happening again.

I am proud to chair the new Democratic Working Group on Regulatory Modernization and we have put together a number of issues we are focusing on. And so, I wanted to give each of you maybe one question that addresses one of those each issues.

To Mr. Washburn, regarding the mortgage reform bill that this committee passed last year, I believe it was in April, but unfortunately didn't get through the Senate and get to the President to become law, in that bill that we passed, we eliminated many of the risky lending practices that contributed to the subprime fallout that has so affected the rest of the capital market structure.

We also put liability to the securitizers to address what Congressman LaTourette I think rightly attributed to, one of the problems was that the originators weren't ultimately going to be holding the bag for bad loans that they might write. And by putting liabilities to the securitizer we also then gave them a home waiver provision; that if they had best practices in place to make sure that the originators were adhering—the ability to pay models and old underwriting standards that used to work, they wouldn't have that liability.

So my question to Mr. Washburn is, how do you feel about that bill, had it become law; and if it had a year ago, would we have avoided the number or the severity of some of the challenges that we are facing in this crisis? Before you go there, I want to lay out a couple of other questions and then we will come back.

To Mr. Yingling, on mark to market, I think the chairman earlier talked about how the real issue—and you just spoke to it briefly—is that the capital calls more than necessarily how you measure, but the consequences of the accounting rules that affect it. My question is, the SEC has changed some of those rules recently, and how do you think that is affecting balance sheets currently with those changes that allow a little more flexibility?

To Mr. Ryan, my question is regarding the uptick in the collateral rules. Earlier in the previous panel, we had some questions about the uptick rule and, if that was reinstated, would it avoid some of the naked short selling that has gone on and contributed to the downward spiral of many securities? But also the collateral role, not just as applied to those, but to the credit default swaps that don't require collateral to get involved in them and how that has allowed so many people to even create greater degrees of risk and leverage, what are your thoughts on that?

And if we get to it with timing to Mr. Bartlett, you talked about a clearinghouse for derivatives and disclosure of risk and what your comments are on that.

So I would like to go to Mr. Washburn first.

Mr. WASHBURN. Could you go back over my question?

Ms. BEAN. Sure. Yours was on mortgage reform which eliminated risky lending practices, put liability to the securitizers so they would make sure the originators did what they were supposed to do to avoid that liability; is that a good thing, is that what we need now? Or do we need something else, because I think that bill would have addressed it. And second, if we had done it, would we have avoided some of this fallout?

Mr. WASHBURN. I think that would have solved part of the problem that you see today. Some of it may have occurred that we could have done nothing about having happen in the past. But I think responsibility is something that the whole industry needs to step forward on. We talked about covered bonds being a way to keep those assets on the balance sheet. In each step those securities were moved from the originator, the less liability you have.

As someone told me recently in a conversation, probably 80 percent of those originators that were out there are no longer in business. So it is just a new day for mortgage origination. I think that might have helped.

Ms. BEAN. Okay. Thank you. Mr. Yingling, it was about the SEC's change.

Mr. YINGLING. The steps the SEC tried to take were marginally helpful. Unfortunately, FASB—they delegated part of it back to FASB and they took us right around in a circle. So marginal progress but really not significant, and I think it shows why the current system doesn't quite work.

Ms. BEAN. If I can, Mr. Chairman. I believe you concurred with the chairman earlier that it should be more about capital cost than changing the accounting rules specifically.

Mr. YINGLING. Well, the way the accounting rules—the impact of the accounting rules need to be changed as opposed to the disclosure.

The CHAIRMAN. It triggers capital requirements at a time when it is a problem. You also have a situation where there are certain entities which by law can't buy certain other entities, and the mark to market can trigger an inability to sell and it is procyclical.

And if you notice, Professor Stiglitz, who is not usually accused of being a shill for the industry, talked also about not having these things be procyclical.

Mr. YINGLING. He did. But just to correct the record, he said that we weren't pure when the market was up. We have raised these questions about mark-to-market accounting being procyclical in up and down. We have raised them for years. You are exactly right, Mr. Chairman.

The CHAIRMAN. Well, if I were you, I would take the agreement I can get and go debate your purity elsewhere. But some arguments are easier to win than others.

I would just say with regard to covered bonds, and this question of what consequences we should flow in a mark to market, will be very high on this committee's agenda next year. We have a very broad set of things to look at that will not stop us from doing some specific things, including continuing our deregulation in the areas of security and others as well.

The gentleman from Alabama.

Mr. BACHUS. Thank you. I will submit a question on the countercyclical capital requirements, which I do believe that is a problem.

The CHAIRMAN. If the gentleman would yield. I would note that on September 18th, the gentleman from Alabama asked that this particular subject be a specific topic of the hearing, so it is something that has our attention.

Mr. BACHUS. Thank you. Mark to market, early on when we started proposing an intervention to buy troubled assets from a small number of large institutions, many members mentioned mark to market. But I want to say this to representatives of the banking group, almost immediately, you all endorsed TARP as a way to solve the problem. I don't want to second-guess you, but it did undercut our efforts to have a more comprehensive program.

I submitted a letter, again October 14th, to the SEC saying that we needed urgent action on this matter. And mark to market is because of Enron and WorldCom. So I am for fair valuation. But the existing interpretation of FAS 157, as you all know and I know, can be done better. And if we continue to place these reduced values on these assets it is going to cancel out, I think, any benefit of capital injection. So to me it is a very important thing. And I know you have my September—I mean October letter to the SEC, and I hope we will join together and continue to push this.

Mr. YINGLING. We agree completely with your letter. They have—at FASB and SEC, within the current rules they have flexibility to make important interpretations.

Mr. BACHUS. Absolutely. And they need to base those values on some reasonable expectation. Now, you know, you have mentioned that we continue to have this debate over regulated or nonregulated, what caused the problem. But now I am going to take issue with this idea that most of these institutions weren't regulated. At some level, they were regulated. If you are talking about the investment banks which, you know, if the investment banks hadn't engaged in what they did, I am not sure we would even be here today. And they were regulated by the SEC, by the CSE program. And it was the SEC that in 2004 let them water down their capital ratios that went from 12 to 1 to 40 to 1.

And you know AIG, is gone today. I mean not gone, they are the subject of a massive bailout. Now, the reason I bring that up is not to get in a conflict with you, but we still have this idea of licensing and registration of mortgage originators. And you know, you and I, we have been on the opposite sides of that. You all have opposed registration and licensing of mortgage originators. You want to just do it for the mortgage brokers, not for those under the regulated institutions.

But, Mr. Bartlett, as you said, or Congressman Bartlett, 40-something percent of the bad actors were working for regulated institutions. We are talking about Golden West, Countrywide, IndyMac, Washington Mutual, a lot of them are at banks. I know you all are continuing to resist my efforts to extend that to all mortgage originators. And I hope you will take a look at this in hindsight—because you all have resisted these efforts for 3 or 4 years in subprime reform—and just say, look, we are there.

I am just going to ask you to continue to look at that. Because, look, if you don't, you are going to have 40 percent of the problem, or it could be 60 percent of these folks who go from one institution to another. They make bad loans in one State, they show up in another State, and it is a big loophole.

Let me ask you this: When you all endorsed the TARP plan, did you not have the same concerns that I expressed from day one, that why would you want those assets to come into the government, you know, to be managed by the government? Wasn't the expertise with the institutions? Wasn't it far better to use covered bonds or lending or preferred stocks to inject the capital in the institution?

Mr. BARTLETT. Congressman, we endorsed it because there is a crisis, an economic crisis. And we think that you have to get capital back into the system to restore liquidity. The Secretary of the Treasury and others have proposed a solution. And we constantly advocated to advance that solution on all fronts and, to add to it, to allow for multiple options. It was a colloquy on the Floor, for example right at the end, that then permitted this or at least referred to investing equity in the institutions.

Mr. BACHUS. And that was that section, I think 118, which we actually insisted on.

Mr. BARTLETT. So we don't see it as one solution, we see it as advancing on all fronts to get liquidity back into the system. And it hasn't started yet. There is not a dollar that has moved yet.

Mr. BACHUS. I just want you to remember that there is a big difference that people seem to be missing. And that is if the government buys these mortgages and mortgage-backed securities and credit default swaps, they have to manage it. And if the institutions themselves aren't able to manage it with all their expertise and experience, how do you expect the government to do that? Mr. Ryan.

Mr. RYAN. I would just like to make one comment. We are very supportive of the TARP program for a different reason. We feel that a major problem in today's financial sector is not only illiquidity in these troubled assets, but price discovery. And the one result which—and as Steve said, we haven't seen this yet, but our hope is that through the purchase program we will have transparency; people will know what an asset is worth; we will actually have a real mark that makes a difference; we won't be debating mark to market; we will know what the price is.

Mr. BACHUS. What about a private auction, or where the private sector has to participate at a certain level?

Mr. RYAN. I am in favor of that.

Mr. BACHUS. As opposed—

The CHAIRMAN. Your 2 minutes are up.

Mr. BACHUS. That is it. Thank you.

The CHAIRMAN. Sometimes I wonder if price discovery is kind of like heartbeat discovery. We are trying to find out if there is one.

The gentleman from Florida is next. The intervening members have agreed to let him go next.

Mr. KLEIN. Thank you, Mr. Chairman. And thank you, gentlemen, for being here today.

When speaking to people at home, large sophisticated borrowers, real estate, and large businesses as well as small businesses, we continue to hear, as you know, that it is difficult to get credit. And I appreciate the fact that community bankers have been very astute in their lending practices over the years. But generally speaking, we are not hearing that there is a lot of capital available. And when we are hearing it is available, it is available under very difficult terms to borrow.

So I want to just—if people are listening at home, watching this today, some would think, based on some of the comments, that some lending is really free flowing out there. Maybe it is in different parts of the country.

I am from Florida, South Florida, and it has been very very difficult. So just as a thought, one of the things we were talking about back home with small business, SBA loans for example, is maybe expanding the underwriting capacity a little bit. Those are high-quality loans for the most part; the default rate is fairly low, and we already have an institution in place. And that is something that, to the extent we can maybe get SBA loans out there quicker, that may be something to consider. I know there has already been an effort to do that, but if we can really push hard, it is a faster way of getting capital in businesses hands. So if you have some thoughts on that.

And then just in general, also to the extent that we know that this is an immediate problem—and there are no silver bullets—whether it is the large, sophisticated borrowers or the smaller borrowers, is there anything that we can or should be doing other than maybe the SBA loans, Treasury, Fed, Congress, that can try to advance the small business side of this thing a little quicker?

And if you could direct that to Mr. Yingling and Mr. Washburn.

Mr. WASHBURN. I think we have always been big proponents of SBA lending, and that is what we do. We are, again, a community bank in Hoover, Alabama, with probably almost 20 percent of our portfolio concentrated in small- to medium-sized business loans. We have worked with the SBA and hopefully will continue to do so. That is a way to get money back out.

As I mentioned earlier in my testimony as well, our loan demand is big, and is great as it has ever been, but capital is holding us back. And so any way to get capital injected into the community bank system, the healthy community bank system will only benefit your area as well as ours and any other area who has a community bank.

Mr. KLEIN. Is that a question of using the $250 billion that is out there and trying to have our community banks and others—I read Mr. Paulson's letter, which I am sure you saw, in terms of everybody has access to us, not just for large institutions. Are you comfortable that that strategy or what you are hearing so far of the application process will get that capital into the community bank system?

Mr. WASHBURN. We hope it will. We have a concern, because right now I think the way it is written, private banks and Subchapter S corporation banks are not eligible or may be left out. We hope there is some change in the dynamics of the bill. But I like what I—the initial read, I like what I see. I think it is a solution. If you read, I think most all the banks that are willing to participate can participate that are healthy. And I think you will see a flow of capital back out, which will result in lending money back into the markets where it needs to be.

Mr. KLEIN. Mr. Yingling.

Mr. YINGLING. I agree with that answer completely. I think one of the problems with this idea of putting capital into community banks is a perception problem. And that is—and you see it on TV, you see it in the media—are we bailing out these banks?

We don't need to bail out these banks. These banks are solid banks, willing to lend, and they don't have to take this capital. But the capital markets are pretty well closed to them right now. So if you want them to have more lending, you have to say, we want you to do this. And in a way, you are a hero to do it. It is not a natural thing for community banks to say, I want a government investment. That is against their philosophy. But they need to know they are not going to have a scarlet "A" around their necks if they do this kind of thing.

Mr. KLEIN. And we are most concerned, obviously from a business point of view, of getting capital and credit available for small business. I mean, we want both capacity, large and small banks to be out there. But to the extent that if you see, as this process is beginning, that your community banks are not having the capacity or the access, for whatever reason, you know, please let our Chair know; and we are all interested, because we want to make sure everyone has the ability if they need it, and it will help the local businesses to get access to this capital, we would like to help.

Mr. YINGLING. You are right and thank you.

Mr. WASHBURN. Thank you very much.

The CHAIRMAN. The gentlewoman from Wisconsin.

Ms. MOORE OF WISCONSIN. Thank you, Mr. Chairman. I guess I want to direct my question perhaps to Mr. Ryan.

One of the things that I have found more frightening than anything, more than these toxic assets, are these credit default swaps. Speculation is that the value, outstanding value is something like $58 trillion, more than twice the size of the U.S. stock market. And I guess the beauty of bankruptcy perhaps would be that we would be able to take advantage, avail ourselves of the discovery process in bankruptcy, where a special master could sort of do an autopsy and figure out what happened and sort of sort this stuff out.

Many of my colleagues and many people on the first panel seem to be enamored with the idea of our having a select committee to pull together all the different jurisdictions and sort of tagging onto that idea.

I guess my question would be, since the judicial jurisdiction is spread out among the Fed, the SEC, FTC, CFTC, FDIC, maybe even the Department of the Treasury, what do you think about—and in the absence of any bankruptcy except for Lehman Brothers, what about having a special master look at this and help us do an autopsy of what happened so that we can do the right thing? Mr. Ryan, I will let you answer.

Mr. RYAN. Thank you. First of all, as to the number, the number that is floated around in the press is a notional number; it is not really the net number once these things are settled out. We are still talking in excess of $1 trillion.

Ms. MOORE OF WISCONSIN. Of what trillion?

Mr. RYAN. $1 trillion, once it is netted out. Fifty is a lot of double counting. That is number one.

Number two, the industry, meaning the financial markets industry, is very engaged right now with the Fed and with regulators in Europe to address the issues with structured and derivative products because it is not just CDS, it is other products. And what we are trying to do is to come up with a system that works. Principally, it is going to be a clearing system. And I expect that we will hear some reasonably positive news about that soon.

Ms. MOORE OF WISCONSIN. Okay.

Mr. RYAN. I don't think we need a special master.

Ms. MOORE OF WISCONSIN. Well, the reason I am asking this question is because maybe I disagree with others, that we don't need to determine in order to move forward; I don't necessarily agree that we don't need to assign some blame in order to discern what has gone wrong. I think that without the judicial and the judicial sort of jurisdictions of all these departments engaged and involved, it is hard to hold people responsible.

My colleague, who had to leave, had a question about credit default swaps as well. And basically her question was, should we have some collateral rules or capital requirements for credit default swaps?

Mr. RYAN. Well, we do. I mean, most of the players in the derivatives business are major financial institutions around the world. They are, by the way, highly regulated. In the United States, those institutions are largely regulated by the Fed, and they have the same capital requirements that apply to all of the institutions represented here. So capital, collateral, are covered right now.

Ms. MOORE OF WISCONSIN. Okay. Well, then why is this so complicated? I mean, if there is—I guess my understanding about these credit default swaps is that one of the reasons that they are so problematic is because there are actually very little, unknown assets underneath them. I mean at least with the toxic mortgage asset products, we know that there is a house and an address associated with it. But some of the betting on top of betting and credit default swap activity is sort of opaque to us.

Mr. RYAN. I am going to make a couple of comments. First, as to the general business of credit default swaps, they are risk mitigators and they serve a very useful purpose on a global basis. Some of the, I would say, concern that exists in today's marketplace and the reason for a lack of confidence is, as I said before, we have taken financial engineering to a level of complexity that people do not understand. Most of the problems, by the way, are not with credit default swaps, they are with other instruments where they were very very complex, and insurance was purchased around those securities, which are called credit default swaps. That is why this is implicated in the discussion right now.

Ms. MOORE OF WISCONSIN. Thank you. I yield back.

The CHAIRMAN. The gentleman from Minnesota.

Mr. ELLISON. Mr. Ryan, maybe you can elaborate on that. What are some of the other instruments besides credit default swaps that are out there that played a role in the current financial meltdown?

Mr. RYAN. As I said before, if we do a retrospective on this, which I believe we will be doing over the next couple of years, we will find that instruments like CDOs, certain types of CDOs, where the underlying assets are really by reference to an index, CDO squares which are a collection—

Mr. ELLISON. Just for the record, CDOs are collateralized debt obligations?

Mr. RYAN. Correct, collateralized debt obligations. And when you had multiple CDOs collected and then securitized and sold, they were called CDO squares.

Mr. ELLISON. Now, another question. If you were to—let's just say you did not have these derivative instruments that have developed, but you did have the poor underwriting standards that were associated with subprime mortgages. Would we be in the financial circumstances we are in today?

Mr. RYAN. Well, clearly many of the underlying assets in these problematic structures were subprime or Alt-A mortgages, mostly subprime.

Mr. ELLISON. I guess my question is, to what degree is the credit default swap proliferation and the derivative market, to what extent did it accelerate the problems associated with the subprime market? Do you understand my question?

Mr. RYAN. I do, and I am not sure that it necessarily accelerated it. What it certainly did was it took these products, packaged them, and structured them in such a way that they could be distributed through the capital markets and distributed globally. So I would say the biggest difference, quite frankly, between the problems we have in the S&Ls between 1989 and 1992, 1993 and today, is we have taken most of these mortgages and we have packaged them in such a way that they could be distributed through the capital markets. That is the biggest difference.

The CHAIRMAN. It sounds pretty accelerating to me.

Mr. RYAN. Excuse me?

The CHAIRMAN. That sounds pretty accelerating to me.

Mr. RYAN. Accelerating?

The CHAIRMAN. Yes. That is what he asked you.

Mr. ELLISON. My next question is, you know, we have been debating over whether or not deregulation was a causal factor in the financial circumstance that we find ourselves in. And I guess my question is, you know—and I think it was the year 2000—I think then-Senator Gramm introduced a piece of legislation, I think it was called the Commodity Futures Modernization Act. To what degree did the passage of this amendment exempt derivatives from regulation? Or in your view, Mr. Ryan, did they? Do you understand my question?

Mr. RYAN. I think I understand your question, but I don't know the answer.

Mr. ELLISON. Does Mr. Bartlett know?

Mr. BARTLETT. I don't know.

Mr. ELLISON. Are you familiar with this piece of legislation, the Commodities Futures Regulations Act?

Mr. RYAN. I am familiar with the fact that the regulation of credit default swaps was an issue at that time, and I believe Congress decided that it would not be regulated as a product. That is what you are talking about.

Mr. ELLISON. Yes. And how much did that decision—well, let me ask it this way: Did that decision by Congress serve the public well, particularly in light of the present circumstances?

Mr. RYAN. I think that is something that time will tell. I am not sure of the answer to that question right now.

Mr. ELLISON. Mr. Bartlett, do you have a view on this?

Mr. BARTLETT. I don't have a conclusion. I have a lot of views. The first view is that setting up this clearinghouse, the New York Fed setting up a clearinghouse, we will know more about it. And then over the course of the next several months, I think that we will have a full debate as to whether to regulate credit default swaps through either CFTC or the Federal Reserve.

I haven't reached a conclusion yet, but I do think it is fair to say that the question has been reopened.

Mr. ELLISON. And the last question. We have talked about some of the economic history, Glass-Steagall and then the move to Gramm-Leach-Bliley. And the way I understand Gramm-Leach-Bliley—I wasn't in Congress then—is that it allowed financial institutions to leave their area of core competency and sort of do things that they traditionally had not been doing. What now is the best regulatory approach to address the current circumstances?

I mean, I guess we could have repealed Gramm-Leach-Bliley and returned to a Glass-Steagall-type era, or we could try to modernize, as I guess that is the topic of today's hearing. What strategies should we pursue if we are going to try to meet the financial opportunities opened up by Gramm-Leach-Bliley?

Mr. YINGLING. The one comment I would make is that Gramm-Leach-Bliley had nothing to do with this. I mean Gramm-Leach-Bliley didn't have anything to do with mortgages or mortgage origination. It didn't have anything to do with Fannie or Freddie. It didn't have anything to do with AIG. It didn't have anything to do with Lehman Brothers or Bear Stearns. In fact, Bear Stearns and Lehman Brothers were stand-alone securities firms.

In a way, Gramm-Leach-Bliley has provided an exit because Merrill Lynch was able to be acquired by Bank of America, and Goldman Sachs and Morgan Stanley were, because of Gramm-Leach-Bliley, able to get under the Federal Reserve. And in fact, Gramm-Leach-Bliley had some good capital provisions in it.

So I think that argument, in my opinion, is misguided. I do think that Gramm-Leach-Bliley was incomplete in the sense that we did not have—and I keep coming back to this—a systemic regulator. And that is what we really need is a systemic oversight regulator.

The CHAIRMAN. Thank you. I think that point is fascinating. The gentleman from Alabama wanted to take 30 seconds.

Mr. BACHUS. Let me credit default swaps, and correct me if I'm wrong—I would compare in the real world with sort of insurance or a guarantee. I mean it is a form of where you are issuing insurance on an obligation. Now, the problem with it was, unlike insurance, where there are reserves and it is regulated, when you make a guarantee you have to have reserves to stand behind it. It was so highly leveraged that you may issue some on a $100 million obligation. When it went wrong there was only, you know, $200,000 worth of capital backing that guarantee and it was blown through almost immediately.

The CHAIRMAN. If the gentleman would yield, the analogy, I think, is that these were people who were issuing life insurance on vampires. They didn't think they needed any money because vampires don't die. And then when the vampires died, they didn't have any money.

Mr. BARTLETT. Well, just briefly, the problem with credit default swaps was its excess leverage to the extreme and then no systemic regulation at all. I mean none.

The CHAIRMAN. If you don't think you are ever going to have to pay it off, then you don't worry about your obligations.

Mr. BACHUS. It was an incredibly leveraged guarantee with no reserves backing it.

The CHAIRMAN. The gentleman from—

Ms. MOORE OF WISCONSIN. Will the gentleman yield?

The CHAIRMAN. Yes.

Ms. MOORE OF WISCONSIN. So did I use the wrong term by calling them credit default swaps instead of CDOs?

The CHAIRMAN. They are two different issues. They are two different things.

Ms. MOORE OF WISCONSIN. So would your answer change?

The CHAIRMAN. Gwen, we don't have time.

Ms. MOORE OF WISCONSIN. No problem.

The CHAIRMAN. The gentleman from Colorado.

Mr. WILSON. Thank you, Mr. Chairman. You can see from the conversation that the setting we have to try to solve all the ills of the financial markets by asking you all 5 minutes' worth of questions doesn't quite meet the issues that we have to confront.

But just a couple of things, and then I have a bunch of questions. This applies to Mr. Ryan or Mr. Washburn. I came out of the 1980's, the savings and loans, the oil and gas bankruptcies, all of that stuff, and a lot of community banks failed back then. And the good news is we are not seeing that. It is sort of a different sector of the financial industry that has been struggling.

But there was an article yesterday by Robert Samuelson, entitled, "The Trouble With Prosperity." It says, if things seem splendid, they will get worse. Success inspires overconfidence in excess. And if things seem dismal, they will get better. Crisis spawns opportunities in progress. And we see that kind of—those ups and downs within the financial market.

Now, one of the things that I want to ask about is we see within community banks in particular, smaller banks, credit unions, less interconnectness—I think that was somebody's terminology, interconnectness—that has allowed them to be not immune from all of this, but at least in a better financial position than those groups that were very interconnected. And whether it is Gramm-Leach-Bliley or not, you have banks, investment banks and insurance companies, all, in my opinion, kind of wrapped up in one big thing.

I would like a comment on that if you could, Mr. Washburn or Mr. Ryan. And then I want to talk about money markets, because we went through a whole heck of a lot. We went through two hedge funds failing, we went through a failure of Bank Paribas, we had the lockup in the student loans and the municipal bonds, we had Bear Stearns, we had Fannie Mae, we had Freddie Mac, we had

AIG go down, and Merrill Lynch. And then we got involved when the Treasury ran over here because there was a run on money markets. So I want to talk about how do we deal with money markets. So first question, interconnectedness.

Mr. WASHBURN. I think you are correct. The lack of that interconnectedness is what made the community bank model successful. And there were failures back in the time you mentioned. But if you look at the overall economy we are still doing—or the overall industry, we are still doing the same thing we have done for years. I mentioned earlier we are lending money to people who pay it back. And we offer some peripheral services that are tied into our client base. So us extending what we normally do, extending into markets we don't understand and into products and services we don't understand, we shied away from that. I don't see that changing going forward, so yes, I think that is correct.

Mr. WILSON. Mr. Ryan.

Mr. RYAN. Clearly, we have cyclicality at work and there are certain types of institutions that are affected more by the pressures they are under—15 years ago it was the smaller banks, and now it is, I use the word "interconnected" financial institutes. That is the principal issue. It is why our principal recommendation is to have a systemic regulator. And we need one on a global basis. So that is as to the first question.

As to the second question, you know, your litany of the problems we have been dealing with over the last 2 months, it tells the whole story as far as the crisis atmosphere. The issues with money markets are also interconnected with many of the other issues because the market funds were investing in what they thought were very high-level AAA and AA bonds to support the money markets. We are, I would say, very, very pleased at the way the Treasury stepped in, because we cannot afford to have the money markets break the buck. So the fact that they used the emergency stabilization fund quickly and then came to you in the form of TARP, we think was critical in stemming the tide. So we thank you for your help on that.

Mr. WILSON. And then to Mr. Bartlett or Mr. Yingling, both of you were talking about under TARP, I think there are three things that we could do. And I would ask that you talk to your members about it. One is, you know, buy the junk portfolios, whatever you want to call them, the troubled assets. Two, recapitalize the banks. And the third one is—and this I got in a colloquy with the chairman—is that we can use this $700 billion to go directly through the SBA, go through the Federal Home Loan Bank system or get to the community banks directly and the Farm Credit Administration, because there is fury out in, you know, Wheat Ridge, Colorado, about money getting down to small businesses and to people. I mean, there really is a huge amount of anger about all of this.

And so one of the things that I would ask all of you to take back to your members and also continue to promote is that there is a way through this whole thing we have done to get it directly down to the people on the street, the small businesses on the street, the homeowners on the street, the bankers and the farmers. But I didn't get that in there. It is not as crisply written as I would like, but it is in the record. Thank you.

The CHAIRMAN. The gentleman from Indiana.

Mr. DONNELLY. Thank you, Mr. Chairman, Ranking Member Bachus, and members of the panel. We want to try to help create proper regulations as we move forward. But the question I have is regarding the executives running your companies, the people in charge. Do they get the sense of responsibility that they have, because folks back home in Indiana who played by the rules and who worked hard have been damaged extensively, personally by this. And this is a crisis of confidence. Can you tell everybody that the executives of these companies get it now? That they are not chasing a way to get a higher bonus through a risky leverage program? Is there a code of conduct in place? Have they talked about that?

I would like you to speak as to these people that you talk to every day. And do they understand they not only have an obligation to their shareholders, which I understand, but to this country; that the people investing their dollars in their organizations are going home and looking at their kids and trying to make sure they can make ends meet every day.

Mr. BARTLETT. Congressman, the executives of my companies feel a heightened and a strong sense of responsibility, a sense of accountability, and a sense of accountability for getting it right and moving forward. I do have to say it is easy to say "they." I am sure that each of the 435 Members of Congress have a sense of responsibility also.

Mr. DONNELLY. Absolutely.

Mr. BARTLETT. And so each of us has a responsibility to get it right. This crisis sort of melted down and there is a lot of blame. But these executives take it seriously, and it is a sense of total commitment to get it right.

Now, I do want to say one other thing, and that is that the sense of "they" is that they are not to blame. Clearly there were individual companies and individual executives who made mistakes. But if you look at these companies—U.S. Bank, Raymond James, Prudential Financial, Wells Fargo, PNC, Frost Bank, Bank Corp South of Tupelo, American General in Evansville, Indiana—it is neither accurate nor—well, it is not accurate to sort of broad brush and say, well, all of those people are somehow—

Mr. DONNELLY. And nobody is doing that.

Mr. BARTLETT. I know you weren't.

Mr. DONNELLY. What we are trying to do is to say to everybody who may be watching that they can be confident, that they can look to these organizations and know that their funds will be protected.

And so what I am wondering is, is there some code of conduct that we won't invest in these type of products; that these are areas we will stay out of. We have exceptional leaders.

You know, I am familiar with the banks and institutions in my home State. Our community bank leaders and credit union leaders and others have been off the charts in their solid nature and what they have done. And what I am trying to do is to tell the folks back home why they can have this confidence.

Mr. BARTLETT. Congressman, to take one more minute. In fact, these executives have, and the executives I work with have a total commitment to get it right, to work with the Congress and with the regulatory agencies to get it right. It was a systemic failure.

And I will use one example of one company in Indiana. American General had one of the lowest rates of delinquencies of the subprime market and one of the largest subprime lenders in the country, 2 percent rate of delinquency. And yet they are owned by AIG. The credit derivative swaps was the problem that brought the whole company down. But it wasn't the subprime loans that were being made in Evansville, or throughout the country, from Evansville, Indiana. So it is a systemic failure, not a failure of individual parts. It is the fact that the parts didn't have a mechanism to talk to one another.

Mr. DONNELLY. And I know as a leader with them, you will be talking to them about—and they of course know, we hope going forward, what areas they don't want to get into. They don't want to go near, in terms of just the things you were talking about, the credit default swaps that may not have been backed up.

And then to Mr. Washburn, what are the things that we can do to make it easier for our small businesses to be able to get loans? How can we be able to make sure that those who are so creditworthy, coming to you, that the funds are there? What are the things the community banks and small banks are looking for as we move forward?

Mr. WASHBURN. I think the number one thing that—and again I am speaking for 8,000 banks, but I think the number one thing that we see as a need for us is capital. We may be a little bit unique, but we are in a high-growth area, and opportunities are great at this time, as I have mentioned a couple of times today.

The access to capital and stabilization of the market, I think there is fear out there that has just caused a lot of the lenders to sit on the sidelines not knowing what is coming next. So I think a combination of those, the possible fear going away, capital injected into the markets, and just the ability to get the system moving again.

Mr. DONNELLY. Thank you.

The CHAIRMAN. The gentlewoman from California.

Ms. SPEIER. Thank you, Mr. Chairman. And thank you for being here and for your participation. I will make this painless because I know I am the last to ask questions here.

One of the things that is very apparent to me, and I think to all of us really, is if you have no skin in the game it is really easy to make mischief and get out there. And a lot of that went on in this crisis. You all are supportive of ceasing mark to market. And yet I worry that if we do in fact get rid of mark to market, that it is going to create an environment where banks can take on risks because there is not going to be the accountability that mark to market requires.

So my question is, are you interested in seeing mark to market suspended for a short period of time because we are in this crisis, and then return to it? Or are you supporting doing away with mark to market completely?

Mr. BARTLETT. Congresswoman, I would like to start. There may be slightly different variations. But I think that mark to market or fair value accounting needs to be reformed to where it actually obtains a fair value. If there is no market of a daily market then you can't use the market of a transactions to achieve the market. And we believe that is part of the law, that is part of good accounting principles, and that what we have urged is that FASB and the PCLB use the fair value accounting in its proper way, which is if there is no market then use a cash flow model to estimate the value.

Ms. SPEIER. So you still support mark to market?

Mr. BARTLETT. Yes, we do. We don't support a return to historical cost accounting. But currently the system is broken because it is being regarded in many places as a theology rather than an accounting method. And so we want to move back to good accounting and away from the theology of it.

Ms. SPEIER. Mr. Ryan.

Mr. RYAN. Just to get the record straight—at least within our industry representing, really, the financial market players, these are global players—that we do not have the same uniform view expressed by the other panelist on mark to market accounting. So that is from an industry standpoint.

From a personal standpoint, and this goes to the point you just made, it is a pretty difficult time period to make a change to the accounting as we are in the middle of a crisis. And that is especially true when pricing and confidence in the system is so critical. So when you at this juncture, just on a personal basis, I have a hard time supporting a change in accounting exactly today.

I think that we all need to look at overall accounting standards and how they apply to the financial services business because there are other accounting conventions that have also caused problems. So the whole issue as we start looking at how do we want to be regulated in the future, we need to put the accounting profession into this system and think through broadly the impact the accounting profession has had on this industry.

Ms. SPEIER. To you, Mr. Yingling, you said something earlier in your testimony that kind of stunned me. You said you kind of gasped when you saw the number of loans that were being offered with no money down, and that government should have done something. Well, I guess my first reaction is, why didn't you come to Congress and say, hey, there is a problem here, we need to fix it, instead of sitting back and looking at it? We don't look at your figures on a daily basis. You are in a position to do that.

Mr. YINGLING. That is a good question. By that point in time, we were already well into it, and so we did come up here and work with the chairman and this committee on the legislation that ultimately passed the House. So by that point in time, it was too late.

Part of the problem is these statistics, largely again, were outside the banking industry. And so we weren't looking at them, we weren't looking at the mortgage brokers. And my point was I don't think there was anybody in the government that was really looking across the whole spectrum of what was going on in mortgage lending.

And so, yes, we probably should have seen it earlier because it had a terrible impact on our industry. But at that point, we were already well into the problem.

Ms. SPEIER. Last question: I met with a national investment firm CEO last week who said to me, “We are not about to invest in any bank right now because we can’t tell what they have.” And he was speaking particularly of Wachovia and how there is no transparency. If we can’t find out what they are holding, why would we invest?

So my question to you as the head of the ABA is, how far are you willing to go out in terms of transparency within the industry? And that is my final question.

Mr. YINGLING. Well, we should have full transparency. I think the problem is in this dynamic, you not only have trouble seeing what may be in a loan portfolio, you really have trouble knowing what it is going to be worth 2 months from now or 3 months from now because the market is changing so rapidly. But, yes, we ought to work on issues of greater transparency.

Ms. SPEIER. Thank you.

The CHAIRMAN. The gentleman from Ohio had a question.

Mr. LATOURETTE. Thank you very much. Mr. Ryan—I am going to ask the chairman unanimous consent—when you were talking to Ms. Moore, this issue that has been in the newspaper about $53 trillion of securitized stuff out there, and I think you said $1 trillion.

Could you supply for the record, and I ask the chairman unanimous consent for permission to do that, why you say it is $1 trillion and not $53 trillion?

The CHAIRMAN. Thank you. Mr. Yingling, I would like to ask you a question. You said no one in the government was looking at mortgages across-the-board. At what period were you making that comment about?

Mr. YINGLING. I would say, it is just my impression, that if you go back to 2003, 2004, 2005, or 2006, maybe the Federal Reserve was looking at that.

The CHAIRMAN. I want to take serious exception to that. It wasn’t your job to know differently. But there is a fundamental issue here. In 1994, under John LaFalce’s leadership as the second Democrat, and Chairman Gonzalez was chairman, this Congress passed the Homeowners Equity Protection Act.

Mr. YINGLING. I understand that.

The CHAIRMAN. That said that the Federal Reserve should regulate mortgages. And it was assumed at the time that the bank regulators were regulating the mortgages on the regulated institutions, but that the Fed should do across-the-board mortgage regulation, knocking out a lot of things that should happen. Well, this is an important point, and it is not what you said.

Mr. Greenspan, under his philosophy of deregulation, refused to use it. Now it is true, as some of my colleagues over there said, the law was on the books. But Mr. Greenspan said, no, the market is smarter than I am, and explicitly refused to use it. Federal Reserve Governor Gramlich urged him to use it, and he refused on philosophical grounds. Finally, frustrated that that wasn’t happening, in 2005, four members of this committee—Mr. Bachus, who was then the chairman of the Financial Institutions Subcommittee as a Republican, Mr. Watt of North Carolina, Mr. Miller of North Carolina, and myself—began conversations to adopt legislation. So it is simply not true that no one was looking at this.

In 2005, we began negotiations among us to adopt a bill to do what Mr. Greenspan wouldn't do, to restrict subprime mortgages that shouldn't have been granted. Those negotiations went on for a while, and I was then told by the then-chairman of the committee—I think Mr. Bachus got the same message—the Republican House leadership did not want that to go forward. And the efforts ended.

In 2007, when I became the chairman, we took that issue up, and we did pass a bill in 2007. And Mr. Bachus, who voted for the bill, indicated he thought some of the people testifying had been against it, but we did pass a bill that would restrict most of these things.

But here is some good news, and we don't like to talk about the good news for some reason. Even though that bill didn't pass in the Senate, which is a phrase you hear quite a lot these days, or forever, Mr. Bernanke, after the House acted, and in conversation with the House, then used exactly the authority that Alan Greenspan refused to use, and has promulgated a set of restrictions on subprime mortgage origination which will stop this problem from happening again. So the problem was twofold.

And this is what the acceleration question is, Mr. Ryan. The weapons that destroyed the financial system of the world were the subprime loans. They shouldn't have been granted. A lot of people, certainly myself included, but top-ranked officials, all thought that while this would be damaging, the damage would be confined to the mortgage market. What very few people understood was the extent to which subprime damages would rocket throughout the system. And yes, it was the super sophisticated, not very well-understood, and not very well-regulated financial instruments that took these subprime loans and spread them around.

Now, we have solved part of that problem going forward because, thanks to Ben Bernanke, acting after the House moved, there will be no more of those subprime loans. Ben Bernanke's rules are pretty good ones, and everything I would like to do. And we want to go further on yield spread premiums and elsewhere.

The problem is that while subprime loans won't be the weapon that is loaded into these super sophisticated instruments and shot around, there may be something else. So that is why the second part of the job, having seen that subprime loans don't go forth, the second part of the job is what we have been talking about today—and you have all been very helpful and we appreciate it—how do we put some constraints on excessive risk-taking in the financial system so the next time—and nobody can be sure it won't happen—loans are made that shouldn't have been made, we don't have them multiplied in their effect.

But I did want to say it is really not fair to say that no one was looking at subprime loans. Many of us were doing it in 2005, and even earlier, trying to get Mr. Greenspan to do it.

Yes, Mr. Yingling.

Mr. YINGLING. Could I clarify my response, then? I am not saying that people weren't looking at—and I was here for all that history, so I know exactly what you are talking about. I am not saying people weren't looking at it from the point of view of consumer protection, and maybe weren't looking at it correctly from that point of view. And I think you have made this point before, and that is that consumer protection and safety and soundness are not separate items.

The CHAIRMAN. But by 2005, and you are right, that the Homeowners Equity Protection Act had a consumer protection orientation. That was in the days before people really understood credit default swaps—or maybe they never do—but they weren't there. But by 2005, I guarantee you that when we were talking about this, we were talking about not just consumer protection, but about the systemic damage that could be done. We underestimated it, but we knew there would be systemic damage.

Mr. YINGLING. I guess my comment, then, is I don't know how regulators could look at that graph from a safety and soundness point of view and not say, whoa, we have a big problem.

The CHAIRMAN. Well, you have to ask Mr. Greenspan, because he explicitly did. I mean look, this is a deep philosophical approach. Mr. Greenspan explicitly said in Mark Zandi's book, Greenspan's deregulatory failure, it is very clear there were fundamental philosophic issues here. And we are debating—and Mr. McCotter raised it, and Mr. Price raised it in very thoughtful ways. We are now discussing what the role is of regulation.

But I agree, I think Mr. Ryan said it best in terms of—and others, and Mr. Yingling and Gramm-Leach-Bliley, this is not a case so much of deregulation as a case of not adopting appropriate new regulations to keep up with innovation. It is not that old rules were dismantled, it is that as the system innovated, appropriate new rules were not adopted. And that is what we need to do. But I do want to say on subprime we were looking at it from the systemic point of view as well as the consumer protection.

Mr. YINGLING. And should it not be the explicit requirement of a systemic overview regulator when they see something like that to address it?

The CHAIRMAN. Yes, it should be. And you know what? While I think we need to fix it up, if you had asked me 10 years ago if that was part of Alan Greenspan's general mandate, I would have said I thought it was. So I regret the fact that we have to make it more explicit, because we wouldn't have had as much damage.

The hearing is adjourned. The record is open for any submissions.

[Whereupon, at 3:02 p.m., the hearing was adjourned.]

A P P E N D I X

October 21, 2008

Statement by Rep. Michele Bachmann
House Financial Services Committee
Hearing on Regulatory Restructuring and Reform of the Financial System
Tuesday, October 21, 2008

Thank you, Mr. Chairman, for holding this important hearing on regulatory reform of our nation's financial system.

As we all know, America has experienced incredible turmoil in its financial markets over the last six months. It is important that we quickly review the history of how we got here.

Lenders made risky loans to less creditworthy borrowers with Congress' encouragement and with the confidence of Fannie Mae and Freddie Mac's taxpayer-guaranteed shoulders to lean on. Investors in the secondary mortgage market made risky, overconfident decisions to fuel this behavior and purchased mortgage-backed securities they believed were backed by the U.S. taxpayer, again through Fannie and Freddie. Senior executives at Fannie and Freddie continued to push for larger portfolios, and thus more risk for the taxpayers, and Congress did nothing to slow the growth of these government sponsored enterprises (GSEs). In fact, Congress encouraged further growth.

As a result, the American taxpayer bailed out bad decision-makers from all parties to the tune of more than a trillion dollars: $29 billion for Bear Stearns, $200 billion for Fannie and Freddie, $300 billion to expand the Federal Housing Administration (FHA), $85 billion for AIG, and of course, $700 billion for the giant Paulson Plan -- plus $110 billion in sweeteners to pass that plan.

Congress could have taken steps before the September adjournment to make sure both American taxpayers and the integrity of our financial markets would be protected in the future. Rather than taking a mere short term glance at today's market problems, it could have stayed in town a bit longer and hashed out more long-term solutions to these issues. It is unfortunate that this was not accomplished.

Our Committee must move forward and take a serious look at where to go from here. And the first place we should look is at the heart of this debacle: Fannie Mae and Freddie Mac. Fannie and Freddie must be reformed so that taxpayers do not continue to fuel their risky, unrestrained growth. Congress's failure to address that root cause will likely lead us right back to this point again in the future.

Our Committee should consider proposals like the *Government Sponsored Enterprises Free Market Reform Act*, introduced by our colleague, Rep. Jeb Hensarling. This legislation would put Fannie and Freddie on the road to becoming free market, healthy competitors in the secondary mortgage market instead of the government-run, taxpayer-backed giants they are today.

Our Committee should also exercise its oversight authority to shed light on the management decisions made by former executives who were in charge of Fannie and

Freddie during this period of unrestrained growth. The American people deserve to have full transparency about their decisions which have burdened taxpayers by the trillions.

Mr. Chairman, I hope you will reconsider our request, led by Ranking Member Bachus, to hold Committee hearings that examine why Fannie and Freddie rapidly expanded their purchasing and securitization of subprime mortgages from 2005-2007. We should hold former executives of the GSEs accountable and ask them the same questions our constituents are asking us about their management practices.

Again, I thank the Chairman for holding this important hearing.

October 21, 2008

Contact: Alison M. Mills
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Statement of Congressman Mike Capuano
House Committee on Financial Services
The Future of Financial Services Regulation
October 21, 2008

"As we work through this tumultuous economic period our primary focus must be on efforts to improve the economy. However, we cannot postpone the analysis of our current regulatory structure and the role that it played in the financial difficulties the country is now experiencing. I think it is clear that existing regulations are just not sufficient to address the reality of today's financial services industry."

"I thank Chairman Frank for calling today's hearing, continuing the necessary review of our regulatory framework. The issue of regulatory reform is one that I have personally identified and pushed for years in Congress. There is no question that we must have a renewed focus on this issue in light of the current economic situation. I think it is extremely important that as we engage in this review, we take deliberate and thoughtful steps toward real regulatory reform. Rushing through reactive measures can miss important aspects of the problem and potentially create overly burdensome regulations that push the pendulum too far to the other side".

"I look forward to the testimony from all of today's witnesses as we go through this process of reviewing what works, how the existing framework should be altered and how much additional regulation is now necessary to provide the transparency and oversight that has been so clearly lacking."

OPENING STATEMENT OF CONGRESSMAN PAUL E. KANJORSKI

COMMITTEE ON FINANCIAL SERVICES

HEARING ON REGULATORY RESTRUCTURING AND REFORM OF THE FINANCIAL SYSTEM

OCTOBER 21, 2008

Mr. Chairman, we have reached a crossroads. Because our current regulatory regime has failed, we now must design a robust, effective supervisory system for the future. In devising this plan, we each must accept that regulation is needed to prevent systemic collapse. Deregulation -- along with the twin notions that markets solve everything while government solves nothing -- should be viewed as ideological relics of a bygone era.

We also need regulation to rein in the private sector's excesses. In this regard, I must rebuke the greed of some AIG executives and agents who spent freely at California spas and on English hunting trips after the company secured a $123 billion taxpayer loan. Their behavior is shocking. The Federal Reserve must police AIG's spending and impose executive pay limits. If it does not, I will do it legislatively. After all, the Federal Reserve lending money to AIG is no different from the Treasury investing capital in a bank.

Returning to our hearing's main topic, I currently believe that the oversight system of the future must adhere to seven principles. First, regulators must have the resources and flexibility needed to respond to a rapidly-evolving global economy full of complexity and innovation.

Second, we must recognize the interconnectedness of our global economy when revamping our regulatory system. We must ensure that the failure of one company, one regulator, or one supervisory system does not produce disastrous ricocheting effects elsewhere.

Third, we need genuine transparency in the new regulatory regime. As products, participants, and markets become more complex, we need greater clarity. In this regard, hedge funds and private equity firms must disclose more about their activities. The markets for credit default swaps and other derivatives must also operate more openly and under regulation.

Fourth, we must maintain present firewalls, eliminate current loopholes, and prevent regulatory arbitrage in the new regulatory system. Banking and commerce must continue to remain separate. Financial institutions can neither choose their holding company regulator nor evade better regulation with a weaker charter. All financial institutions must also properly manage their risks, rather than shifting items off balance sheet to circumvent capital rules.

Fifth, we need to consolidate regulation in fewer agencies, but maximize the number of cops on the beat to make sure that market participants follow the rules. We must additionally ensure that these agencies cooperate with one another, rather than engage in turf battles.

Sixth, we need to prioritize consumer and investor protection. We must safeguard the savings, homes, rights, and financial security of average Americans. When done right, strong consumer protection can result in better regulation and more efficient markets.

Seventh, in forcing financial firms to behave responsibly, we must still foster an entrepreneurial spirit. This innovation goal requires a delicate, but achievable, balancing act.

In sum, we have a challenging task ahead of us. Today's esteemed witnesses will help us to refine my seven regulatory principles and ultimately construct an effective regulatory foundation for the future. I look forward to their thoughts and to this important debate.

Remarks Prepared for Submission by
Honorable Peter T. King
House Committee on Financial Services
Regulatory Restructuring and Reform of the Financial System
October 21st, 2008

Mr. Chairman, I thank the Committee for holding this hearing today on the "Regulatory Restructuring and Reform of the Financial System." We are truly standing at a critical juncture in the future of our regulatory system and I look forward to hearing the witnesses' testimony on proposed improvements to its structure.

I voted for the Emergency Economic Stabilization Act (H.R. 1424) because the American credit system was paralyzed, making it virtually impossible for businesses or individuals to obtain a loan.

Failure to unclog the credit markets would prevent companies from meeting payrolls; make it very difficult to obtain home mortgages, driving down the value of our homes; and block access to student loans and car loans. This would devastate our entire economy. The central component of the legislation authorizes the Treasury Department to spend $700 billion purchasing troubled assets from financial institutions. If successful it will inject liquidity into the credit markets and enable loans to be made. This legislation was not a "bailout" of Wall Street but an attempt to protect the financial security of Americans throughout our economy - - including people who rely on their pensions and 401(k) plans.

But just as my constituents are outraged at the need for such a rescue, I am angered that we ever came to these crossroads to begin with. I look forward to hearing testimony which hopefully will shed light on how the repeated failure to enact reform of Government-Sponsored Enterprises (GSEs) and the subsequent fraud, misfeasance and malfeasance in the mortgage and mortgage-backed securities markets led to this international crisis. I also look forward to learning what next best steps our panels propose as we move forward to once again try to improve our regulatory structure.

We need to swiftly identify steps that can be taken to assure that we do not travel again down the dangerous road that produced the current crisis. Answers are critical to the reassurance of the public that our government can be trusted to ensure the stability of our economic system.

SHORTER STATEMENT

Regulatory Reform Hearing

October 21, 2008

Thank you, Mr. Chairman, for calling us here today. This hearing begins to address what the American people are demanding: real reform of our economy. My father owned a small, five-and-dime variety store in my hometown of Cleveland. He often took me to work with him, and as a result, I carry with me to this day a real appreciation for a hard day's work. He also taught me some basic principles of credit worthiness, only borrowing what you could pay back, living within your means and other values that most Americans live by.

Those values are reinforced today when I talk to my constituents in South Florida and hear their stories about their retirement savings in a freefall, their businesses having a hard time getting credit and their family budget being stretched thin.

As we have all unfortunately come to understand, this financial crisis was caused in part by a lot of smart people exploiting loopholes combined with lax or non-existent regulation and oversight.

The result is now one of the most volatile economic times in American history.

Unemployment is skyrocketing, property values in many areas have plummeted, and one in 11 mortgages is delinquent or in foreclosure.

My home state of Florida has been especially hard hit. Many of my constituents are business owners who are worried about meeting payroll. Others are retirees, worried about the security of their investments. Still others are homeowners impacted by our area's sky-high foreclosure rates, resulting in a diminishing value of their property and their neighbor's property and in many cases, mortgage balance that is higher than the fair market value of their home.

These trends are very serious and we must find answers to get our economy back on track. One of the ways we will get our economy back on track is to rebuild and restore confidence in our financial system. This hearing is an important step in looking back to see what went wrong , learning from those mistakes, and bringing together experts from various backgrounds and perspectives to help build a financial system that restores confidence.

As we look at this picture, I believe that we must consider the following proposals:

1. **Update and improve regulation:**

Our current regulatory framework is duplicative and outdated. We need a system that works with the financial markets that exist today and a system that will evolve with the financial market of the future.

The SEC must absolutely review the role and performance of the Credit Rating Agencies and their ability to accurately reflect the risks of investment securities. There appears to be an inherent conflict of interest in their role of being an "independent" evaluator of risk and value of financial instruments when they are being paid their fee by the party offering the investment. There is an important role for an independent agency to value an investment, but we must think through a different way of doing it.

We must also allow regulatory agencies to do their job by giving them the authority to oversee newer financial instruments, like credit default swaps. There should also be a discussion as to the amount of leverage that can be applied to those instruments. Our regulatory agencies also have to take a stronger oversight role to prevent fraudulent and manipulative trading practices.

Smarter regulation does not mean burdening business; rather, our economy will be stronger with more effective oversight.

2. **Encourage competition among financial institutions**

Consumers must have more options. One of the problems that is contributing to this mess is that some of our institutions are "too big to fail." I don't like that term and I don't like what it implies. On the one hand, we abandon our principles of anti-trust regulation and enforcement so that there is more and more consolidation of market power in a few organizations; then, when risky and bad business decisions are made, which threaten failure of these large businesses, we say that the business is so integrated and intertwined with other businesses that the damage would be greater to our economy if we allow the market forces to work and let the business go under. In other words, under our current system, a business may be super-successful and profitable until it makes incredibly bad business decisions and then comes to the federal taxpayer to keep it from collapsing. That is a really bad place to be.

We need to return to a real free enterprise system, where real competition works and no one is given a competitive advantage or disadvantage by the actions or inactions of government.

3. **Establish a Financial Product Safety Commission**

Our regulatory agencies must have the right tools to conduct improved oversight so that the American people can be confident that their money is secure. Whether it is a new, malleable, evolving version of the SEC or CFTC or combination of the two, or a new Financial Product Safety Commission, we need to rethink and put in place a regulatory and oversight organization that promotes good business practices, gives clear information to consumers to make good investment decisions and protects the American taxpayer.

There are many other recommendations that I look forward to hearing about today, and implementing as soon as possible. Mr. Chairman, thank you once again for calling this urgent hearing.

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C. 20515

Donald A. Manzullo (IL-16)
Opening Statement
Regulatory Restructuring and Reform of the Financial System

Mr. Chairman: Thank you for holding this hearing today. We continue to face the biggest financial crisis since the Carter Administration. This committee needs to examine ways to ameliorate the impact of this crisis while examining long-term solutions to ensure that a crisis of this magnitude never happens again.

It has become common knowledge that Fannie Mae and Freddie Mac, with their unethical and illegal practices, were at the root of this crisis. A few of us in Congress have long identified their special treatment as a recipe for this disaster, and our efforts to combat their overreach is a matter of public record. Over the past eight years I have cosponsored three bills that would have reformed Fannie Mae and Freddie Mac and required the higher capital requirements that would have eased, if not prevented, the onset of this crisis. In 2000 I confronted Franklin Raines over Fannie Mae's fraudulent lobbying campaign. In 2004, I again called into question Fannie Mae's accounting fraud that appeared motivated by higher bonuses for Fannie Mae's staff. The unchecked fraud and abuse at these institutions is staggering and has cost the taxpayers millions. This is a clear indication that Fannie and Freddie should undergo significant reform and that their role in the housing market should be seriously reconsidered.

The reckless dash of Fannie and Freddie toward "homeownership for all" caused further tears in the economic fabric. Forced to comply with the appetites of the government-backed Fannie and Freddie for subprime and CRA loans, the private market began to give mortgages to anyone and everyone—including those who had absolutely no ability to pay. Regulators, while acknowledging that such loans were amiss, pledged too great a faith in the housing bubble to address its unstable foundation. In fact, only now has the Federal Reserve issued a common-sense rule that would require individuals to present proof that they can afford a subprime mortgage before they receive it. Amazingly, this rule won't be finalized until late 2009. In July, I questioned Fed Chairman Bernanke about the delayed timing and implementation of this rule when such action could have done much to prevent the full scale of this crisis that we are now facing.

It is clear that reform of our financial system is nécessary. However, reform should be carefully tailored to prevent the stifling of the growth and innovation that characterizes the American economy. Reform and regulatory changes should continue to encourage American jobs to remain in the United States, and not provide an incentive for them to move overseas.

An example of these targeted reforms are those featured in H.R. 7223.

- Limit Federal Backing for High Risk Loans: We need to mandate that Government Sponsored Enterprises no longer securitize any unsound mortgage that is: (1) not fully documented to meet minimum requirements for work, assets, and income; (2) written to comply with any law or regulation that would otherwise violate a firm's lending rules.
- Schedule the GSEs for Privatization: We must transition Fannie and Freddie over a reasonable time period to truly private companies without special government privileges and open them up to real market competition. This reform would: 1) establish commonsense limits for their capital requirements and portfolio holdings relative their size; 2) focus their mission on affordable housing only, not profit making; 3) require them to pay an appropriate risk-based amount for the government guarantee they enjoy; 4) subject them to state and local taxes and accurate SEC filings like every other private for-profit corporation; and 5) ultimately provide for the phase out their GSE charters once their conservatorship has ended.
- Suspend "Mark to Market" Accounting: We should direct the SEC to suspend the mark-to-market regulatory rules until the agency can issue new guidelines that will allow firms to mark these assets to their true economic value. The current rules contribute to a downward spiral as firms have to evaluate their assets not on the basis of their long-term investment but rather on a short-term mania.
- Strict Enforcement of Laws Designed to Protect Investors: Congress must task the SEC with reviewing the annual audit reports of entities the federal government has brought under conservatorship or now owns, and determine if those annual audit reports from years 2005 to present accurately reflected the financial health of those businesses.
- Encourage the Federal Reserve to Expedite its Final Rule: As I previously discussed, the Fed has issued a common-sense rule that would require people to show proof that they

could afford a mortgage before they receive it. Right now, this rule will not take effect until 2009. Given the state of our economy, this is unreasonable, and we should encourage its expedited publishing.

I also support other meaningful and targeted approaches to regulation, such as those issued in a bill by my colleague, Representative McHenry. His legislation, H.R. 6230, would require credit rating agencies to provide additional disclosures with respect to the rating of structured securities. Such a measure would ensure that credit rating agencies adequately evaluate credit risks. Other thoughtful measures should be considered as well, such as those that would spread sunlight on the derivatives market as a way to prevent the failure of huge giants such as AIG.

As this financial crisis continues to take its course, it is important that all solutions be examined thoroughly and with a full and fair debate. We must not allow the greed and corruption that was so frightfully evidenced on Wall Street and at Fannie and Freddie to continue unchecked and without consequence. The American taxpayer deserves a long term solution that punishes civilly, and possibly criminally, those responsible for driving our economy to the brink, addresses the current problems we are facing, and ensures that a crisis of this magnitude never, ever happens again.

Thank you, Mr. Chairman for the opportunity to issue a statement. I look forward to hearing from the witnesses and continuing with the proceedings today.

PETER J. ROSKAM
6TH DISTRICT, ILLINOIS

COMMITTEE ON FINANCIAL SERVICES

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October 21, 2008

Statement for the Record: Regulatory Restructuring and Reform of the Financial System
House Committee on Financial Services

Chairman Frank, Ranking Member Bachus,

Thank you for holding this important hearing. Today we have a real opportunity to forge an economic system even more durable than that which we have now. In the tremendous stresses and pressures we have endured thus far, we have gained experience and great knowledge about our financial system, and even greater insight into how to manage its exigencies. I look forward to the bipartisan work ahead of us to develop a more resilient financial system that can better serve the American people and avoid future financial calamities.

In my view, moving forward, we need a financial regulatory framework in this country that can contemplate financial innovation. We need a refurbished financial infrastructure to guard against systemic risk, protect consumers, and foster an environment where innovation and risk taking can be executed responsibly, and rewarded amply. It is my hope that we can set aside partisanship and develop just such a regulatory framework that will not stifle American enterprise with the overbearing, heavy hand of compliance costs, but rather one that will spur economic growth with an infrastructure that frees American enterprise to flourish.

To accomplish this end, we need to take a step back from our current situation, and start by envisioning a regulatory system that offers predictability and confidence in the marketplace. We must take a foundational look at our regulatory infrastructure; we ought not charge ahead with partisan arguments about the need for more or less regulation or some other approach.

Indeed, we need to consider how best to equip a regulator with flexibility, responsiveness, and strength in heading off financial hazards. We must preserve the freedom to fail in our economy. Our new regulatory institutions must be able to thwart the systemic dangers that have plagued us in this season, while at the same time maintaining the balanced hope that lingers between the risk to fail and the reward of success.

The American people have for too long been asked to function under a Depression-era regulatory structure. Although our current circumstances present great challenges, we now have a tremendous opportunity to leverage our experiences toward a new age of unprecedented economic growth and prosperity.

Today, I simply wish to offer a word of caution to my colleagues. We must take great care to preserve the capacity for innovation and growth, while also providing an environment that can more accurately and consistently price risk and manage its costs.

I look forward to reviewing the testimony of our witnesses, and to the hard, but hopefully fruitful work ahead of us.

PRosKam

Peter J. Roskam
Member of Congress

Opening Statement
Financial Services Hearing on Regulatory Reform

Thank you, Mr. Chairman, for holding this hearing today. I also want to thank the witnesses for coming before the Committee to discuss this important challenge that we face as a nation.

There is a consensus across America. We all agree that something went horribly wrong in our financial markets. We also agree that something needs to be done. But that, I think, is where the consensus ends.

A few years ago, we all watched as deregulation of the energy industry resulted in rolling blackouts throughout California and made paying the utility bills a struggle for many working families.

Now we are in a similar situation with our financial markets. The cost of this government intervention has gone through the roof and it affects every American, whether rich or poor, working or retired. The blame cannot be laid solely at the feet of deregulation, but that is certainly a good place to start. The lack of enforcement at the SEC would be laughable if it were not cost Americans so dearly.

A few months ago I came across an article written by Dr. Elizabeth Warren. Dr. Warren's article was on establishing a Financial Products Safety Commission, patterned after the Consumer Products Safety Commission. Dr. Stiglitz, you too have written on this, and I would like to explore how we would go about creating such an entity.

Could we transform the SEC into something capable of protecting investors from overly-risky financial products? Or would we have to create a new agency altogether?

I also would like to get this panel's opinion on the regulatory powers held by the Treasury and the Fed. Some troubling stories have come out recently about AIG and some of the banks that are receiving taxpayer money as part of the Troubled Asset Relief Program. We need to take a good hard look at the discretionary powers of the Fed and make sure it has the authority to set criteria for the behavior of institutions who accept our loans.

Our mission here is twofold: While we are collectively putting our fingers in the economic dike, we must simultaneously rebuild to make sure it is not breeched in the future. Part of that rebuilding, I believe, should involve reinstituting Glass-Stegall.

Whatever we build, it must be both stronger and more flexible to withstand the challenges brought by new financial products as they are introduced. As we pull ourselves out of this crisis, however many months or years down the road that will be, some will again bang the drum of deregulation. Let's make sure, before that happens, that we have learned the lessons of this monumental failure and put safeguards in place to protect us in the future.

Thank you Mr. Chairman. I look forward to the panel's answers.

Statement of the

Honorable Steve Bartlett

President and Chief Executive Officer

The Financial Services Roundtable

Before the

Committee on Financial Services

U.S. House of Representatives

October 21, 2008

Chairman Frank, Ranking Member Bachus, and members of the Committee, I am Steve Bartlett, the President and CEO of the Financial Services Roundtable (the Roundtable). The Roundtable is a national trade association composed of 100 of the nation's largest banking, securities and insurance firms. Our members provide a full range of financial products and services to consumers and businesses.

I would like to begin my remarks by commending you and all the members of this Committee for your leadership and actions in the quick passage of the Emergency Economic Stabilization Act (EESA). As a former member of Congress, I appreciate how difficult that vote was for Members of Congress just weeks before an election. However, we are living in extraordinary times that demand extraordinary actions from policymakers.

Passage of that Act was vital to the national interest. Our nation's financial institutions and financial markets are the lifeblood of the economy, and EESA provides Federal officials with the tools needed to stabilize our financial markets and restore economic growth.

The injection of capital into several of the nation's largest financial institutions was the first real exercise of the new law. The Department of Treasury (Treasury), the Federal Reserve Board (Board) and the Federal Deposit Insurance Corporation (FDIC) are now in the midst of implementing a variety of other measures, including the purchase of distressed assets, the issuance of guarantees for the payment of principle and interest on distressed assets, the establishment of a system of guarantees for senior unsecured debt issued by banking institutions, and the purchase of unsecured commercial paper. The Roundtable believes that the combination of these measures should succeed in stabilizing our financial markets and restoring economic growth.

Yet, as you, Mr. Chairman, recognize by convening this hearing, additional actions are needed to establish better, more effective financial regulation that can evolve with developments in global financial markets. Modernizing our financial regulatory structure not only will help to regain the trust and respect of consumers and markets everywhere, but also will preserve our leadership role in the global financial marketplace.

Therefore, Mr. Chairman, the members of the Roundtable applaud your leadership in initiating these hearings. Clearly, recent market events indicate a need for reform in our financial regulatory structure. No one wants to see a repeat of the current turmoil. The financial crisis has exposed some fundamental weaknesses in our financial regulatory system, despite the best efforts of the Treasury, the Board, the FDIC, and other regulators to respond to events as they unfolded and react to the crisis as it developed.

The Roundtable has spent considerable time on this issue in the past several months, and we appreciate the opportunity to share our views on the subject. The rest of my testimony is divided into four parts. First, I will place current events in some context. Second, I will use the mortgage markets to illustrate some of the regulatory gaps and challenges we face. Third, I will outline five specific reforms that the Roundtable recommends for immediate action. These reforms are designed to address certain limitations inherent in our current system of financial regulation. They could be enacted in the short-term as a first "no regrets" move to improve our regulatory system, while more far reaching, long-term structural proposals are considered and debated. Fourth, I identify some additional actions Congress, Treasury, and the federal regulatory agencies should take to address current events.

As for other long-term reforms, the Roundtable is starting a review of all options for regulatory reform, and we will be prepared to give you our view on longer-term regulatory reforms early next year after the new Congress convenes.

I. We Have Reached a "Tipping Point" in Financial Regulation

For many years, the U.S. financial markets and financial institutions were the envy of the world. They provided consumers, businesses, investors, governments, and other organizations with the means to invest, save, and borrow funds. They helped the U.S. reach record levels of GNP and record levels of employment. Likewise, Federal and State financial regulators are dedicated public servants, who have worked hard to maintain the stability and security of our nation's financial system.

It is now clear, however, that we have reached a "tipping point" in financial regulation. The regulatory system that has served us so well in the past was not able to recognize fundamental changes in national and international financial markets and to adapt to those changes in a coordinated fashion.

We have reached this tipping point for many reasons. One of the most significant reasons is our fragmented financial regulatory structure. We have hundreds of Federal and State financial agencies that pursue different missions and rely upon different methods of supervision. This structure is based upon a national policy that dates to the founding fathers, and was improved upon in 1999 with the passage of the Gramm-Leach-Bliley Act (GLBA). That Act permitted banks to affiliate with investment banks and insurance companies under a holding company structure, but limited the authority of the Board over financial affiliates in order to preserve the authority of other Federal and State regulatory agencies.

Some commentators have suggested that the amendments to the Glass-Steagall Act made by the GLBA contributed to the crisis in our financial markets. GLBA did permit banks to affiliate with investment firms, but those affiliations did not contribute to current problems. In fact, GLBA had just the opposite effect. It permitted financial holding companies to acquire distressed investment banks (e.g., Bank of America's acquisition of Merrill Lynch and JP Morgan Chase's acquisition of Bear Stearns). It also has allowed Goldman Sachs and Morgan Stanley to become bank holding companies, subject to comprehensive supervision by the Board.

Historically, there is a strong rationale for functional regulation. It enabled regulators to specialize, and it preserved the regulatory authority of States in our Federal system. Functional regulation also was well suited for a time when the different segments of the financial services industry operated separately with little overlap in terms of products and services. For all of its merits, however, this system of financial regulation is subject to certain limitations that contributed to the recent market turmoil.

First, Federal and State financial regulators lack a common set of regulatory objectives. They do not share a common vision or operate under common principles that balance consumer and investor protection, market integrity and stability, and competition. This has resulted in gaps in regulation, and even conflicts in regulation.

Second, Federal and State financial regulators lack an effective mechanism to communicate and coordinate policies. This limitation has become increasingly significant as the lines between the different segments of the financial services industry have crossed and blurred.

The President's Working Group on Financial Markets (PWG) was established in 1987 to respond to the stock market crash then and to provide some degree of coordination among financial regulators, but its membership is limited to the Secretary of the Treasury, the Chairman of the Board, the Chairman of the Securities and Exchange Commission (SEC), and the Chairman of the Commodity Futures Trading Commission. Representatives of the Federal banking agencies are noticeably absent from the PWG, as well as any representatives of State regulatory bodies. Lacking a better means to coordinate policy actions, individual regulatory agencies focus on compliance with their own rules, and may not have an appreciation for larger trends in the financial services sector.

This clear regulatory gap makes it difficult for regulators to fully appreciate market developments and to adjust policies in response to developments. Today, there is no formal coordinating mechanism that allows all credit market regulators and all capital market regulators to sit around the same table to share information, develop early warning systems, conduct routine scenario planning, and anticipate future financial crises. There is no single point of accountability to consumers and the Congress, and no single point of contact on global financial regulatory issues.

II. Our Fragmented System of Financial Regulation Failed to Respond to Fundamental Changes in Mortgage Finance

The recent turmoil in our financial markets is illustrative of the limitations inherent in our current system of financial regulation. The developments that ultimately led to the current crisis had their genesis in mortgage instruments and structured financial transactions, such as traunched asset-backed securities, collateralized debt obligations (CDOs), and other derivatives.[1] These innovations facilitated an explosion in activity in the U.S. housing market. While credit became more accessible, the development of the "originate-to-distribute" model led to an increased separation between those responsible for risk creation and those who ultimately bore the risk and thus led to a weakening of risk accountability. In short, governance of risk did not keep pace with innovation and market structural changes.

The Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Board, the FDIC, and individual State banking authorities supervise State and national banks that are active in the mortgage markets. However, lacking unified policy goals it took these agencies almost one year to develop guidance on nontraditional mortgage lending, and even then the guidance applied only to federally-supervised lenders, not state-supervised lenders.

In conjunction with the development of the originate-to-distribute model of mortgage finance, mortgage bankers and mortgage brokers assumed a greater percentage of mortgage originations. In 2006, for example, they were involved in 58 percent of the mortgage originations. While these individuals and firms were licensed by most States, State supervision varied widely. Consequently, at a time when the system of mortgage origination and financing was undergoing fundamental change, no single regulatory body had a clear purview or supervisory authority over the entirety of the primary-mortgage market.

The regulation of secondary-mortgage market activity also was divided among several authorities. Freddie Mac and Fannie Mae securitized conforming mortgages, subject to the supervision of an agency, the Office of Federal Housing Enterprise Oversight, which lacked many of the regulatory, supervisory, and enforcement powers available to the Federal banking agencies. Separately, the supervision of the securitization of nonconforming loans by brokers and dealers fell to the SEC, an agency that relies upon disclosure and enforcement to police the activities of brokers and dealers. Many financial services firms regulated by Federal and State bank regulators also were active in securitization and the secondary-mortgage market, but, again, there is no single agency across the secondary markets, or the combined primary- and secondary-mortgage markets, that had a complete picture of what was occurring in the marketplace.

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[1] It should be noted that a root cause of the crisis was a large influx of funds into the U.S. economy from other countries combined with a long-standing national policy to promote homeownership. Subprime loans developed to meet the growing demand for housing and did enable many Americans to own their own homes. It is now clear that many of those subprime loans were made on the basis of continuously rising home values, and when the housing bubble burst, the financial structure surrounding mortgage finance collapsed.

Additionally, credit ratings and accounting policies played a role in recent market events. Favorable ratings on mortgage-based securities and derivative products facilitated the world-wide distribution of these products. As the assets underlying these securities started to deteriorate mark to market accounting distorted their true economic value and led to write downs that resulted in a reduction in credit availability for consumers. Both credit rating agencies and accounting policies fall within the supervision of the SEC, yet that agency lacked any formal mechanism to discuss market developments and appropriate policy responses with Federal and State banking authorities that were overseeing the origination of the underlying assets.

In sum, different Federal and State regulators supervising different parts of the mortgage finance system, without coordination or clearly delineated accountability, increased the potential for excesses and ultimately crisis.

Likewise, when the current crisis erupted, no coordinating body was clearly responsible, and an ad hoc response was required. As the crisis emerged, many observers looked to the Treasury to play a leadership role. However, until the passage of the EESA, Treasury's powers were limited. Before EESA, all the Secretary of the Treasury could do was to call meetings of the PWG and request reports; other than that, the Secretary only had the power of persuasion. Treasury could provide its perspective to the markets, but it was dependant on a variety of other regulatory agencies, especially the Board, to take action.

With the passage of the EESA, Treasury and the Federal financial regulators, especially the Board and the FDIC, have taken extraordinary steps to stabilize markets and set a foundation for the restoration of economic growth. To be clear, in these difficult times, the Roundtable supports the actions taken to date by the Treasury and all the regulators.

III. Roundtable Near-term Recommendations for Reforming Financial Regulation

The Roundtable has five near-term recommendations for reforming our system of financial regulation. Our recommendations are designed to address the limitations in our current system of financial regulation. As I said earlier, these are "no regret" moves that do not stand in the way of more comprehensive regulatory reform in the future if that is deemed necessary.

In response to recent events, we propose a series of targeted, near-term reforms aimed at the lack of common goals and coordination in our current regulatory system. These reforms should not in any way detract from subsequent structural reforms and improvements. Specifically, we propose five reforms:

Market Stabilization – Reduce the potential for systemic risk by giving the Board overarching supervisory authority over systemically significant financial services firms that seek access to the discount window or other financial facilities.

Interagency Coordination – Provide for greater cooperation and coordination among all financial regulators by expanding the membership and mission of the PWG to make it more forward looking.

Principles-Based Regulation – Enable financial regulators to adapt and respond more effectively to changes in markets through the enactment of a set of principles that serve as a common point of reference for both financial regulators and financial services firms. Such principles will guide the review and development of more detailed rules that necessarily follow.

Prudential Supervision – Encourage the early identification of potential financial risks by requiring the application of prudential supervision by all financial regulators to all financial services firms.

Federal Insurance Supervision – Strengthen the oversight of insurance markets and potential insurance risks by authorizing optional Federal chartering and supervision of firms engaged in the business of insurance.

We would not be so bold as to suggest that the implementation of these recommendations would have prevented the current crisis entirely. However, we do believe they would have helped regulators and the financial services industry better appreciate market developments and would have diminished the scope and severity of the crisis. Each of these five integrated recommendations is described in greater detail in the attachment to this statement.

IV. Additional Action Items

Fair Value Accounting

The Roundtable supports use of fair value accounting and not a return to historical cost accounting. We advocate use of a clear-minded system to determine the true value of assets in distressed and illiquid markets. Unfortunately, the current application of fair value accounting is neither clear-minded nor fair. It does not work in these times. It is causing significant damage to individual institutions and the economy as a whole. The SEC's recent clarification and the Board's recent guidance attempted to resolve the issue of valuing assets in illiquid markets. However, additional actions are needed by the SEC and the Public Company Accounting Oversight Board to provide auditors the flexibility in the application of fair value accounting.

Credit Default Swaps

Another element in the current crisis is the impact of derivative products, especially credit default swaps. This is an extremely complex issue, and one that the

Roundtable is still reviewing. However, we do support current efforts by the industry and regulators to establish a clearinghouse for credit default swaps, with better supervision and greater transparency. Such a mechanism should significantly reduce the uncertainty associated with these instruments.

Mortgage Interest Rates

Short term rates, such as the 3-month LIBOR, are starting to drop. Yet, we have not seen any significant reduction in long term mortgage rates since the enactment of EESA. I am hopeful that as EESA continues to be implemented we will see a reduction in mortgage interest rates since that would have a significant, positive impact on individuals and the economy. If mortgage rates do not fall, Congress, Treasury, and the federal regulatory agencies should consider additional appropriate actions.

Economic Stimulus Plan

Today, on October 21st, it is not clear whether and when Congress should consider an additional economic stimulus plan. The need and timing of any such plan should be developed in consultation with Treasury and the Board. If it is determined that immediate action is necessary in a lame duck session, then the plan should focus on: housing, job growth, and capital investment.

We have a housing-led recession. We need a housing-led recovery. The best housing stimulus proposal I have seen is the proposal to allow anyone who purchases a home in 2009 to double the deduction on mortgage interest for two years. This would create a significant incentive for home purchases, and would put a floor on declining home values. Also, going forward, we should keep other options open, including the more efficient use of tax incentives for all homeowners, to replace the mortgage subsidy implied in the role played in the past by Freddie Mac and Fannie Mae.

As for job growth, the best proposal I have seen is a plan for tax credits for newly created jobs.

Capital investment could be stimulated through repairs to infrastructure, and private sector capital could be encouraged through changes in the tax code, e.g., accelerated depreciation.

V. Conclusion

Mr. Chairman, I again commend this Committee for launching a review of financial regulation. This is a challenging task shared by all of us. The key is to find the right balance in regulation. We need a system that provides market stability and integrity, yet encourages innovation and competition to serve consumers and meet the needs of a vibrant and growing economy. We need better, more effective regulation and a modern financial regulatory system that is unrivaled anywhere in the world. We deserve no less. I believe that the five reforms proposed by the Roundtable strike this balance in the near term and are the right next step in the journey you have started. The Roundtable looks forward to working with this Committee in the months ahead on needed reforms to strengthen the U.S. financial system.

Lastly, in these turbulent times, many commentators are looking back to lessons learned during the events of the 1930s. In that spirit, I would like to conclude my remarks by quoting from President Franklin Delano Roosevelt's first inaugural address. That address is well known for his statement that "the only thing we have to fear is fear itself." However, President Roosevelt went on to state that "This Nation asks for action, and action now," and he closed his address by declaring that the American spirit of the pioneer is the way to recovery. "It is the immediate way. It is the strongest assurance that the recovery will endure." This declaration should inspire our collective actions in the days ahead.

FIVE NEAR-TERM REFORMS TO ENSURE THE INTERGITY AND STABILITY OF FINANCIAL MARKETS

The Financial Services Roundtable recommends the following five near-term reforms to our financial regulatory system. These reforms are designed to ensure the integrity and stability of the financial system, while maintaining innovative and competitive markets to serve consumers and support a growing economy.

1. Market Stabilization

To reduce systemic risk, Congress should clarify the authority of the Federal Reserve Board to supervise systemically significant financial institutions that seek access to the discount window and other financial facilities. Recently, the Board has granted access to primary dealers that it does not directly supervise. The Board should now be given explicit authority to supervise systemically significant financial institutions that have access to the discount window or other facilities. Supervision should include appropriate reporting requirements, the authority to examine such firms, and the authority to set capital and liquidity requirements for such firms.

2. Interagency Coordination and Cooperation

To promote cooperation and coordination among financial regulators, Congress should expand the membership and mission of the President's Working Group on Financial Markets. Our fragmented financial regulatory system can be slow to respond to changing market forces, international competition, and the dynamic needs of consumers. It also is slow to identify early warning signs and respond accordingly to potential financial crises. An enhanced Working Group would help Federal and State financial regulators keep ahead of market developments and adopt policies that ensure the stability and integrity of financial markets and financial firms.

Today, neither the current President's Working Group nor the Federal Financial Institutions Examination Council performs this role. No single agency spans all financial markets or is accountable across the entire financial sector of our economy, not even the U.S. Treasury Department. Over the past three decades, when specific events in the financial markets have impacted the U.S. economy, both the Congress and the Administration have empowered the Secretary of the Treasury to assume a leadership role in convening and overseeing various aspects of financial regulation. Based upon these precedents, we propose that the Secretary of the Treasury continue to preside over the enhanced PWG. The Secretary's role would be limited to the oversight of financial regulation and general coordination; the Secretary would have no role in the supervision of any particular institution by a national or State financial regulatory authority or other aspects of an individual regulator's statutory mandate (e.g., prudential supervision by all agencies, monetary policy of the Federal Reserve).

The recent market volatility here at home and around the world underscores the urgent and critical need for better regulation and more effective coordination. It also highlights the growing imperative to better manage the complex structural and regulatory issues that challenge all of us – regulators and firms alike. Better coordination among all Federal and State financial regulators based on fundamental principles, more balanced regulation and prudential supervision, should enable financial services firms and regulators to see issues sooner, understand complicated inter-market workings better, and resolve problems faster. While we may not have been able to avoid all of the fallout from the recent market volatility, an enhanced Working Group would have been the point of first response for a more focused, accountable, and coordinated approach to market issues across all segments of the financial services industry.

The expanded Working Group should include not only the existing members of the President's Working Group, but also other major Federal financial regulators and individuals knowledgeable in State banking, insurance and securities regulation.

The Working Group should be directed, by law, to: (1) serve as a forum in which financial regulators could identify and consider issues related to the regulation and supervision of financial services firms, including investor and consumer protection, and the stability and integrity of financial markets; (2) monitor the health and competitiveness of the U.S. financial services industry; (3) develop early warning systems to detect potential points of weakness or strains in U.S. or global financial markets; (4) recommend coordinated actions for financial regulators and financial services firms, especially in times of market stress or financial crisis; and (5) oversee the implementation of the system of principles-based regulation and prudential supervision by all financial regulators (see recommendations below).

3. Guiding Principles

To enable financial regulators to adapt and respond more effectively to changes in markets, Congress should direct financial regulators to follow a simple set of guiding principles, which would serve as a common point of reference for financial regulators and financial services firms.

Such principles would stand ahead of and guide the application and review of policies, laws, and rules affecting the activities and behaviors of both financial market participants and their regulators. They should be designed to be responsive to the needs of consumers, and should ensure that the regulation of financial services and markets is balanced, consistent, and predictable. We need better regulatory outcomes and behavior.

Such principles would not only enable regulators to focus on desired policy outcomes and material risks to markets, but also reduce the potential for consumers to fall through gaps between the national and State legal and regulatory systems.

Guiding principles can act as a compass for all to follow, but they would not replace the need for more detailed regulations. To the contrary, regulations will remain necessary, especially at the retail level for the protection of consumers. However, once enacted into law, a set of guiding principles would become a touchstone against which all existing and new national and State financial regulations would be evaluated in a policy and legal context. Regulations that are not consistent with the principles would be identified, analyzed, and then revised or eliminated, with regulators recommending changes to existing national or State laws, if necessary, to achieve the intent of the principles.

4. Prudential Supervision

To encourage the early identification and resolution of problems, Congress should direct all financial regulators, including self-regulatory organizations, to adopt a "prudential" form of supervision. Prudential supervision not only can protect consumers, but also can better accommodate the ability of the financial services industry to grow and adapt to a dynamic environment and facilitate the efficient allocation of regulatory resources.

Prudential supervision is a form of supervision in which regulators and regulated entities maintain a constructive engagement to ensure an effective level of compliance with applicable laws and regulations. Prudential supervision relies upon regular and open communications between firms and regulators to discuss and address issues of mutual concern as soon as possible. Prudential supervision encourages regulated entities to bring matters of concern to the attention of regulators early and voluntarily. Prudential supervision promotes and acknowledges self-identification and self-correction of control weaknesses, thereby reinforcing continued focus and attention on sound internal controls. Industry-led solutions to identify weaknesses have proven to be both responsive and effective. Among existing financial services regulators, the Federal banking agencies and the CFTC have the greatest experience with a prudential form of supervision.

The Federal banking agencies rely upon regular examinations and robust internal compliance and audit functions to identify existing or potential violations of law or regulations as well as unsafe and unsound practices. The Comptroller of the Currency recently described this prudential supervisory approach to Congress:

> [O]urs is not an "enforcement-only" compliance regime – far better to describe our approach as "supervisory first, enforcement if necessary," with supervision addressing many problems early that enforcement often is not necessary[2]

Regular, informal exchanges between bank examiners and management allow both examiners and management to raise questions on matters of common concern. Examination reports routinely identify matters that require attention by management. Examiners and other supervisory staff, however, are given a significant amount of discretion, which permits firms to utilize resources to resolve issues, rather than expending them on defending a formal enforcement matter.

Banking agencies expect problems to be identified and corrected internally by insisting upon strong internal controls and audit functions. Sometimes, informal memorandums of understanding are used to identify concerns more specifically and set forth specific corrective actions, to which both the firm and the regulator agree. Less formal approaches to addressing problems usually are successful simply because the failure to take appropriate corrective actions can expose a firm to a range of more formal, and public, enforcement actions, including written agreements, cease and desist orders, removal orders, and civil money penalties. It is generally not necessary for banking agencies to take public enforcement actions, since serious problems should already have been identified with strong compliance and audit functions and corrected. More importantly, banks do not want to be exposed to the reputation risk of public enforcement actions.

Since the passage of the Commodity Futures Modernization Act in 2000, the CFTC also has followed a more prudential approach to supervision. For example, regulated entities that seek to pursue alternatives to the agency's accepted compliance practices are able to engage in a dialogue with CFTC staff and that dialogue often leads to the implementation of a more tailored compliance regime.

Adherence to prudential supervision would facilitate the establishment of an open dialogue and a constructive relationship between regulated firms and regulators. In the current financial marketplace, where complex products are becoming more common, a high degree of public and private sector cooperation will enable regulators to keep up with or even stay ahead of the curve on market innovation and industry developments. This cooperation would result in a higher quality of regulation and compliance over time and, in turn, greater investor confidence.

All of the financial services regulators should develop and enhance a culture of prudential supervision. Agency personnel should be rewarded for learning about problems and working with firms to undertake informal corrective. Cooperation between examiners and firms should be encouraged and rewarded. Likewise, cooperation within

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[2] Statement of John C. Dugan, Comptroller of the Currency, before the Committee on Financial Services of the U.S. House of Representatives, June 13, 2007.

and among agencies should be encouraged. However, enforcement actions would continue to be necessary and appropriate in cases of fraud, serious abuses, egregious behavior or ineffective voluntary compliance.

5. Insurance Regulation

To strengthen Federal oversight over the business of insurance, Congress should provide for the optional Federal chartering and supervision of insurance underwriters and producers.

The business of insurance has grown significantly since the state-based system of insurance regulation was established. It is no longer a local business, bounded by State borders. It is a national and international business. Under the framework of the National Association of Insurance Commissioners, State insurance regulators have attempted to make the state-based system of regulation more uniform. However, insurance regulation continues to vary widely among the States. Even when the NAIC adopts a uniform proposed rule or law, individual States are not compelled to implement such proposals. Furthermore, even States that adopt the same uniform rule or law may administer or implement such rule or law differently. Varying, and potentially conflicting, State regulations not only complicate the operations of larger, multi-state insurers and producers and raise their costs for consumers, but also impede their ability to meet the needs of those same consumers.

The state-based system of insurance regulation also has an impact on global competition. Because U.S. insurers lack a national regulator who can negotiate international agreements, the industry is not adequately represented in trade negotiations, and this fact limits the industry's access to foreign markets and its ability to meet the needs of consumers globally. While the NAIC and individual State regulators have been involved in some aspects of international trade negotiations, U.S. trade negotiators have a uniquely difficult challenge. Our trade negotiators must try to obtain concessions from other countries when they know that the United States cannot commit on a reciprocal basis.

Similar challenges have arisen within other international regulatory settings. The International Association of Insurance Supervisors (IAIS) currently is working on several proposals regarding worldwide industry standards, including standards for solvency, accounting, collateral, and regulatory transparency. The United States, through the NAIC, participates in IAIS meetings. However, it is understood that no one representative from the United States can make any decision or commitment that is binding on the entire U.S. market. Therefore, despite participation by the NAIC, U.S. firms simply do not have an adequate representative at IAIS discussions.

An optional national system would give insurers and producers a choice between State or national regulation and supervision. To provide a true option, continued efforts to modernize and improve the efficiency of the State regulatory system should be supported. Modeled after the dual banking system, a system of dual insurance regulation of comparable strength would promote the flexibility needed to respond to a changing market, promote product innovation, promote competition, and ensure consistent consumer protection. In other words, the creation of this option would not spell the end of State regulation. State regulation would continue to be a preferred option for the many insurers and producers that would continue to operate on a local basis, and under the pending Congressional bills, State regulation would remain in place for certain mandatory coverage, such as workers' compensation.

U.S. House of Representatives
Committee on Financial Services
Statement of
Manuel H. Johnson
October 20, 2008

The current state of the U.S. financial regulatory system is the result of an extreme breakdown in confidence by the credit markets in this country and elsewhere so that U.S. regulatory authorities have determined it necessary to practically underwrite the entire process of credit provision to private borrowers. All significant U.S. financial institutions that provide credit have some form of access to a Federal Reserve liquidity facility at this time. All institutional borrowers through the commercial paper market are now supported by the Federal Reserve System. Many of the major institutional players in the U.S. financial system have recently been partially or fully nationalized. While it appears that the Federal Reserve along with other central banks has successfully addressed the fear factor regarding access to liquidity, there are lingering fears in the markets about the economic viability of many financial firms due to the poor asset quality of their balance sheets.

All of these measures to restore confidence are the result of huge structural and behavioral flaws in the U.S. financial system that led to excessive expansion in subprime mortgage lending and other credit related derivative products. Because these structural problems have encouraged distorted behavior over a long period of time, it will take some time to completely restore confidence in the credit markets. However, over time as failed financial institutions are resolved through private market mergers or asset acquisitions in government takeovers and restructurings, confidence in the U.S. credit system should be gradually restored. Unfortunately, this process will likely be very costly to U.S. taxpayers.

Over the longer term, the public should be very concerned about the implications of the legislative and regulatory efforts to deal with this crisis of confidence. From my perspective, permanent government control over the credit allocation process is economically inefficient and potentially even more unstable. One of the major reasons why excesses developed in housing finance was a failure of federal regulators to adequately supervise the behavior of bank holding companies. Specifically, the emergence of special investment vehicles (SIVs), an off-balance-sheet innovation by bank holding companies to avoid the capital requirements administered by the Federal Reserve, set in motion a virtual explosion of toxic mortgage financings. While the overall structure of bank capital reserve requirements was sound relative to bank balance sheets, supervisors were oblivious to bank exposures off the balance sheet. If bank supervisors could not police the previous and much less pervasive regulatory structure, you can imagine the impossibility of policing a vastly more extensive and complicated structure. Again, while bank capital requirements are reasonably well designed, it is supervision that is a problem.

The U.S. financial system has been the envy of the world. Its ability to innovate and disburse capital to create wealth in the U.S. and around the globe is unprecedented. A new book by my colleague David Smick, titled *The World Is Curved*, documents the astonishing benefits the U.S. financial system has provided in the process of globalization. The book also clearly describes the dangers presented by regulatory and structural weaknesses.

It would be a mistake to roll back the clock on the gains made in U.S. finance over the last several decades. As the current crisis in confidence subsides and stability is restored, U.S. regulators should develop clear transition plans to exit from direct investments in private financial institutions and attempt to roll back extended guarantees to credit markets beyond the U.S. banking system. Successfully supervising the entire U.S. credit allocation process is simply impossible without dramatically contracting the system. More resources and effort should be put into supervision of bank holding companies. Financial regulators should focus on full transparency in securitization development and clearing systems. Accurate disclosure of risks is the key to effective and sound private sector credit allocation. Reforms following these principles should help maintain U.S. prominence in global finance and enhance living standards both domestically and internationally.

"Preliminary Thoughts on Reforming Financial Regulation"

Testimony of Alice M. Rivlin*
The Brookings Institution and Georgetown University

Committee on Financial Services
U.S. House of Representatives
October 21, 2008

Mr. Chairman and Members of the Committee. Past weeks have witnessed historic convulsions in financial markets around the World. The freezing of credit markets and the failure of major financial institutions triggered massive intervention by governments and central banks as they attempted to contain the fallout and prevent total collapse. We are still in damage control mode. We don't yet know whether these enormous efforts will be successful in averting a meltdown. But this Committee is right to begin thinking through how to prevent future financial collapses and make capital markets work more effectively.

Pundits and journalists have been asking apocalyptic questions, "Is this the end of market capitalism? Are we headed down the road to socialism?" Of course not! Market capitalism is far too powerful a tool for increasing human economic wellbeing to be given away because we used it carelessly. Besides, there is no viable alternative. Hardly anyone thinks we would be permanently better off if the government owned and operated financial institutions and decided how to allocate capital. But market capitalism is a dangerous tool. Like a machine gun or chainsaw or a nuclear reactor, it has to be inspected frequently to see that it is working properly and used with caution according to carefully thought out rules. The task of this Committee is to reexamine the rules.

The essence of market capitalism is that individual incentives for economic gain (sometimes known as greed) can be harnessed to maximize economic growth; channel capital into its most productive uses; and even reduce the risks inherent in economic activity. Yet there are plenty of clear examples of unfettered gain-seeking leading to

* The views expressed in this testimony are those of the author and should not be attributed to the staff, officers or trustees of the Brookings Institution or Georgetown University.

disastrous collective results—greenhouse gas emissions, for example. The answer to such misalignment of individual and collective incentives is not to abolish markets, but to realign incentives so that markets function better in the collective interest. Cap and trade systems for greenhouse gas emissions are an attempt to do just that.

The financial market crisis provides an opportunity to rethink why individual gain-seeking under current rules led to disastrous results and how to change the rules for the future. Getting financial market regulation right is a difficult, painstaking job. It is not a job for the lazy, the faint-hearted or the ideologically rigid--applicants should check their slogans at the door. Too many attempts to rethink regulation of financial markets in recent years have been derailed by ideologues shouting that regulation is always bad or, alternatively, that we just need more of it. The "less" v. "more" argument is not helpful. We don't need more or less regulation; we need smarter regulation.

Moreover, writing the rules for financial markets must be a continuous process of fine-tuning. In recent years we failed to modernize the rules as markets globalized, trading speed accelerated, volume escalated, and increasingly complex financial products exploded on the scene. The authors of the financial market rule books have a lot of catching up to do. But they also have to recognize that they will never "get it right" or be able to call it quits. Markets evolve rapidly and smart market participants will always invent new ways to get around the rules.

Plenty of blame to go around

It is tempting in mid-catastrophe to point fingers at a few malefactors or identify a couple of weak links in a larger system and say, "Those are the culprits; if we punish them, the rest of us will be off the hook." But the breakdown of financial markets had many causes of which malfeasance and even regulatory failure played a relatively small role. Americans have been living beyond our means, individually and collectively, for a long time. We have been spending too much, saving too little, and borrowing without concern for the future from whomever would support our over-consumption habit—the mortgage company, the new credit card, or the Chinese government. We indulged ourselves in the collective delusion that housing prices would continue to rise. The collective delusion affected the judgment of buyers and sellers, lenders and borrowers, builders and developers. For a while the collective delusion proved a self-fulfilling prophecy—house prices kept rising and all the building and the borrowing looked justifiable and profitable. Then, like all bubbles, it collapsed as housing prices leveled off and started down.

Bubbles are an ancient phenomenon and will continue to recur, no matter what regulatory rules are put in place. A housing bubble has particularly disastrous consequences because housing is such fundamental part of our everyday life with more pervasive consequences than a bubble in, say, dot.com stocks. More importantly, the explosion of securitization and increasingly complex derivatives had erected a huge new superstructure on top of the values of the underlying housing assets. Inter-relations among these products, institutions, and markets were not well understood even by the participants and certainly not by the rest of us. But it is too easy to blame complexity, as in, "Risk models failed in the face of new complexity." Nonsense--too many people failed to asked common sense questions, as in, "What will happen to the value of these mortgage-backed securities when housing prices stop rising and begin to fall?" They didn't ask because they were profiting hugely from the collective delusion and did not want to hear the answers. Bubbles always provide out-sized opportunities for quick profits. They exacerbate greed and fraud and provide excuses for the suspension of common sense. Can we fix this problem by regulation? I doubt it. It is hard to legislate common sense.

<u>What needs to be fixed</u>

Nevertheless, the bubble and the crash were exacerbated by clear regulatory lapses, perverse incentives that had crept into the system, and instances where regulated entities—and even the Federal Reserve--were being asked to pursue conflicting objectives at the same time. These failures present a formidable list of questions that the Committee needs to think through before it rewrite the rule book. Here are some of the items on that list.

Regulatory gaps. The most obvious regulatory gap is also the easiest to fill. We failed to regulate new types of mortgages—not just sub-prime, but Alt-A, no doc, etc—and the lax, sometimes predatory--lending standards that went along with them. Giving people with less than sterling credit access to home ownership at higher interest rates is basically a good idea, but it got out of control. Most of the excesses were not perpetrated by federally-regulated banks, but the federal authorities should have gotten on the case and imposed a set of minimum standards that applied to all mortgage lending. We can argue about what those standards should be, but they should include minimum down payments, proof of ability to repay, and evidence that the borrower understands the terms of the loan. Personally, I would get rid of teaser rates, penalties for pre-payment, and interest-only mortgages. We may not need a national mortgage lending regulator, but we need to be sure that all mortgage lenders have the same minimum standards and that these are enforced.

Another obvious gap poses a far more difficult question: whether and how to regulate complex derivatives? Much of the financial crisis stemmed from over-leveraged unregulated trading in complex financial derivatives. The question is: should we clamp down on the leverage or on the products themselves? I incline to think that we will be more successful if we operate on the leverage by imposing higher capital requirements on all financial institutions that have any claim on federal help if they are in danger of failing. We should also improve the transparency of derivatives, but I doubt it would be useful to screen classes of derivatives before allowing their sale. Charging a regulator with the task of weighing the risk-spreading value of a class of complex derivatives against the risk posed by the complexity itself strikes me as too hard to pull off.

Perverse incentives. One case of perverse incentives is that the commissions of mortgage brokers are bigger if they bring in higher interest (i.e., riskier) loans. I am not sure how to correct this, someone should be charged with making sure that the borrower understands how the mortgage broker is compensated and encouraged to shop around for a better deal.

Another clear case, it seems to me, is that rating agencies are compensated by the sellers of securities. We should find a way to have rating agencies paid by the buyers of securities instead. This suggestion is often scorned by economists, who say it poses a "free rider" problem, but I think that could be handled by requiring that all investment funds over a certain size pay a small percentage fee to support the services of rating agencies.

A much harder question is what to do about the fact that widespread securitization of mortgages (and other consumer lending) disconnects the lender from the borrower and creates incentives for the lender to ignore repayment risk. Don't worry about the credit-worthiness of the borrower: just make the loan, sell it to someone else and move on. Securitization has many benefits—and we cannot go back to the days when small town bankers were afraid to lend to working people lest a local plant closure wipe out the bank's mortgage portfolio. However, we certainly need to clear up the legal responsibilities of loan originators, servicers, packagers and owners of mortgage-backed securities (MBS). We need to ask whether the social utility of slicing up MBS into risk tranches to be sold to investors with different appetites for risk is worth the confusion that ensues when the loan has to be renegotiated. I would favor giving bankruptcy judges the power to adjust mortgages as they do can do with other debts, but it also has to be clear who is on the other side of the mortgage transaction.

Conflicting incentives.

An example of conflicting objectives that need to be resolved concerns the future role of Fannie Mae and Freddie Mac. These institutions were told that they were private companies whose job was to make money for their shareholders and that they should not expect federal help if they failed. At the same time, they were told to further the public purpose of expanding affordable housing and put some of their profits into revitalizing low income communities. While the collective delusion held, these objectives were compatible. Fannie and Freddie borrowed huge amounts--arguably at marginally favorable rates because lenders did not believe they would be allowed to fail—bought a lot of mortgages, including subprime, made high profits, and supported a lot of worthy projects. But their rapid growth helped fuel the bubble, and when the collective delusion collapsed, they had to be taken over by the government. In the end we will have to decide whether we want Fannie and Freddie to be public utilities supporting the secondary mortgage market or truly private (and presumably much smaller) private entities that disappear into the private financial sector. But that is a discussion for the distant future. Right now we need Fannie and Freddie to provide support for the faltering mortgage market. Debate over their ultimate status will have to wait.

Another example of conflicting objectives is the responsibility of the Federal Reserve to mitigate asset price bubbles. The Fed has clear responsibility for the stability of the whole economy. It must use monetary policy (a limited tool at best) to keep the economy growing at maximum sustainable rates and restrain inflation when it threatens to derail growth. Asset price bubbles pose a difficult dilemma for monetary policy: when should the Fed try to slowdown growth in the whole economy to control an emerging bubble in some class of assets? The Monday morning quarterbacks of monetary policy have criticized the Fed for not raising interest rates in 1997-98 to curb the dot.com bubble. (Have they forgotten that inflation was falling and that the aftermath of the Asian/Russian financial crisis was causing a credit crunch?) Critics also blame the Fed for failing to raise interest rates in 2002-03 and the first half of 2004 to curb the housing bubble. (Have they forgotten the slow recovery from the recession of 2001?) While it is not realistic to expect the Fed to pursue several objectives simultaneously with the one blunt instrument (the federal funds rate), we certainly need to be more creative about curbing asset bubbles. Maybe we have to invent another instrument specifically aimed at slowing asset bubbles. At a minimum, we could charge the Fed or some other entity with issuing warnings that some class of asset prices is getting out of line. The entity so charged would need strong protection from political interference.

Moving the boxes on the organization chart

My partial list of hard questions does not include a grand new structure of regulatory relationships such on the U.S. Treasury's *Blue Print for a Stronger Regulatory Structure (2008).* There is certainly both fragmentation and overlap in the current structure. State regulation of insurance companies is an extreme example of fragmentation, and the responsibilities of the Federal Reserve, the Controller of the Currency, and the Federal Deposit Insurance Corporation certainly overlap with respect to regulation of commercial banks. Nevertheless, I don't think neatening up the organization chart deserves high priority in a campaign to make regulation more effective. I am skeptical both of the workability of the Treasury's proposal for organizing regulation by objective rather than function and of the British model of centralizing regulation in a separate Financial Services Agency. Rather, I would start where we are and work to clarify and strengthen the roles of the agencies we have. I would beef up the mandate and resources of the Securities and Exchange Commission (SEC) and clarify the role of the Federal Reserve in insuring that bank holding companies manage their risk competently. In this role, the Fed could be required, not just to pose the common sense questions about risk to the executives of financial behemoths, but to meet periodically with their boards of directors to focus their attention on better risk management.

Thank you, Mr. Chairman and members of the Committee.

TESTIMONY OF
T. TIMOTHY RYAN, JR.
PRESIDENT AND CEO OF THE
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ON THE FUTURE OF FINANCIAL SERVICES REGULATION

OCTOBER 21, 2008

Introduction

Chairman Frank, Ranking Member Bachus, and members of the Committee:

My name is Tim Ryan and I am President and CEO of the Securities Industry and Financial Markets Association ("SIFMA").[1] Thank you for your invitation to testify at this important hearing.

While I am speaking on behalf of the securities industry today, from 1990 to 1993 I served as Director of the Office of Thrift Supervision, with responsibility for regulatory oversight of the nation's approximately 2,000 thrifts. During that time, I also was a principal manager of the clean-up effort following the savings and loan debacle of the 1980s. That experience gave me an acute appreciation for the

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers locally and globally through offices in New York, Washington, DC, and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

importance of effective regulation and the challenges we face as we work through the current crisis.

As we all know, debt and equity markets across the globe have experienced severe dislocations in recent months. Congress aggressively responded to these challenges in the United States by passing the Emergency Economic Stabilization Act of 2008 (the "EESA"), legislation granting the Treasury Department extraordinary tools designed to promote confidence in the U.S. financial system. We fervently hope that the steps being taken will unfreeze the credit markets and restore calm to our equity markets. Congress has rightly recognized, however, that addressing the immediate crisis is only half the battle. Serious weaknesses exist in our current regulatory model for financial services, and without reform we risk repeating the errors of the recent past. Thus, I commend you, Mr. Chairman, and the Committee, for beginning the process of reexamining our regulatory structure with a view toward effecting meaningful improvements.

We also should recognize that financial markets are global in nature. Individual U.S. and non-U.S. securities firms operate in all major markets around the world.[2] As such, we need a global approach to financial regulatory reform. Close cooperation among policy makers on an international basis will play an important part in effectively addressing weaknesses in financial regulation. In this regard, we believe the October 18th announcement by President Bush that he plans

[2] For example, the two largest non-bank-affiliated broker-dealers at the end of 2007 each had offices in over 23 different countries.

to hold a summit meeting of world leaders to discuss the global financial crisis is a good start.

SIFMA stands ready to be a constructive voice in this critically important public policy dialogue—in the U.S. and abroad—to restore confidence in the global financial system. Our members understand the value that a well-designed and implemented regulatory system brings to our markets. We believe that an international effort is required to develop such a regulatory system with common principles that limits regulatory arbitrage between and among countries.

In our view, a sound regulatory regime must contain several key elements. First, it must be designed to minimize systemic risk to the financial system. Second, it must promote the safety and soundness of each regulated financial institution. Third, it must contain business conduct rules that promote fair dealing and investor protection. Fourth, it should be consistent from country to country. And finally, it is critical that the regulatory structure be as effective and efficient as possible. Regulation imposes meaningful costs on our financial system and over-regulation or inefficient regulation can diminish the competitiveness of markets vis-à-vis better regulated venues. Thus, well-crafted regulation—by which I mean regulation that achieves its goals and does so in a cost effective manner—is an important objective.

I. A Financial Markets Stability Regulator

As you know, our nation's financial regulatory structure dates back to the Great Depression. That regulatory structure assumed, and even mandated to some extent, a financial system where commercial banks, broker-dealers, insurance companies and other financial institutions engaged in separate businesses and offered separate products, largely within local or domestic borders. The intervening years have seen remarkable changes in the financial services industry, both in terms of consolidation within the banking, securities and insurance lines of business, and in terms of expansion in the scope of products and services being offered by individual firms. Financial institutions no longer operate in single product or business silos or in purely domestic or local markets. Instead, they compete across many lines of business and in markets that are largely global and competitive across borders.

But the financial regulatory structure remains largely siloed at both the state and federal levels, reflecting the siloed financial structure of yesteryear. This creates a gap between the regulatory structure overseeing financial markets and the modern structure of the financial markets themselves. While there may be good and sound reasons to continue regulating our financial markets based largely on banking, securities, insurance or other functions, no single regulator currently has access to sufficient information or the practical and legal tools and authority necessary to protect the financial system as a whole against systemic risk.

Accordingly, we believe Congress should consider the need for a financial markets stability regulator that has access to information about financial institutions of all kinds that might be systemically important, including banks, broker-dealers, insurance companies, hedge funds, private equity funds and others. This regulator should have authority to use the information it gathers to determine which financial institutions actually are "systemically important," meaning institutions that would likely have serious adverse effects on economic conditions or the financial stability of other entities if they were allowed to fail as a result of a "run on the bank" or other loss of short-term liquidity during a financial crisis. We believe this is a relatively small number of financial institutions. We think it is important that a stability regulator's information gathering be coordinated with other regulators to avoid duplication of oversight and unnecessary regulatory burden. Moreover, any confidential information gathered in this process should remain confidential, unless otherwise publicly disclosed.

Congress should give thoughtful consideration to the additional powers that might be given to the financial markets stability regulator. Among other things, they could include the authority, alone or in coordination with the institution's functional or prudential regulator, to set consolidated capital requirements at the parent company level and to recommend capital requirements at any subsidiary level, to examine the parent company and any of its subsidiaries, and to bring enforcement actions. In short, its powers could correspond to those that the Federal Reserve currently has as the umbrella supervisor of bank holding companies, but we believe it would not be appropriate to include the authority to impose the kind of activity restrictions that apply to bank holding companies.

Further powers that Congress could consider giving to the financial markets stability regulator or some other more specialized federal agency would be "prompt corrective action" and resolution powers over systemically important financial institutions. These resolution powers could be similar to those that the FDIC has with respect to insured depository institutions, including the power to put the institution into conservatorship or receivership, and to create bridge institutions similar to bridge banks to facilitate an orderly disposition of a failed institution's assets and liabilities.

If Congress does take the approach of creating a financial markets stability regulator, it would be important to ensure that it has the appropriate stature, reputation, and tools to be effective. It also is important, however, that it not become an additional layer of regulation. Rather, Congress should consider the stability regulator in the context of the overall streamlining of our financial regulatory system.

II. Additional Steps to Improve the Efficiency and Effectiveness of Regulation

We believe there are other steps that Congress should consider in connection with a financial regulatory reform effort. While financial products and services, and the activities of financial firms generally, have become significantly more complex in recent years, financial services regulation has not kept up. Modernizing financial regulation should be a priority for regulatory reform by Congress. In general, financial regulations should encourage institutions to behave prudently and incentivize them to implement robust risk management programs.

Securities, banking, and insurance products often have very similar economic characteristics, yet they may be subject to very different rules—for example, with respect to capital, margin requirements, or customer protection. These differences distort economic decision making by businesses and their customers, and Congress and regulatory agencies should work to eliminate them wherever possible.

We also believe Congress should consider how financial regulation can be streamlined to be more effective. Duplicative federal and state regulation is one area for review. Another is the separate regulation of securities and futures. When the Commodity Futures Trading Commission was formed, the overwhelming majority of futures products were agricultural in nature. Today financial futures constitute the lion's share of the futures business and the similarities between many securities and futures products, as well as the links between those markets, are significant. The U.S. should merge these regulators in the interest of regulatory efficiency; combining their jurisdiction would be consistent with the approach taken in other financial markets around the world.

Congress also should consider merging the Office of Thrift Supervision into the Office of the Comptroller of the Currency in order to achieve greater efficiency in the operation of federal bank regulatory agencies. In addition, Congress should consider the creation of a federal insurance charter and federal insurance regulator.

III. International Cooperation and Coordination

Another lesson from the current financial crisis is that markets are global in nature and so are the risks of contagion. If financial regulation is to be effective, we believe that common regulatory standards should be applied consistently across markets. Accordingly, we urge that steps be taken to foster greater cooperation and coordination among regulators in major markets in the U.S., Europe, Asia, and elsewhere around the world. There are several international groups in which the U.S. participates that work to further regulatory cooperation and establish international standards, including IOSCO, the Joint Forum, the Basel Committee on Banking Supervision, and the Financial Stability Forum. Congress should support and encourage the efforts of these groups. Moreover, as it considers regulatory reform in the United States, Congress itself should be mindful of the importance of regulatory and legislative solutions that work on a global, cross-border basis.

IV. Structured Products and Derivatives

Innovation has generated many new financial products in recent decades that have the basic purpose of managing risk. Credit default swaps ("CDS") are an example and in recent years the CDS market has grown exponentially. CDSs are an important tool for managing credit risk, but they can also increase systemic risk if key counterparties fail to manage their own risk exposures properly. SIFMA recognizes the risks inherent in this market and will continue to work closely with the International Swaps and Derivatives Association, the Futures Industry Association, and other stakeholders in an effort to create a clearing facility for CDSs that will reduce operational and counterparty risk. Establishing a clearing facility also will enhance the ability of regulators to monitor activities in the CDS market.

We are particularly concerned about efforts to regulate these products at the state level. We believe state-by-state regulation is not appropriate and could result in the business moving off shore, thereby creating more risk. Implementation of a clearing facility is an effective and efficient way to address regulatory concerns.

V. Adequacy of Regulatory Resources

As Congress considers the future landscape of regulatory reform, it must ensure that appropriate resources are dedicated to the regulatory effort. Regulatory agencies need to be appropriately funded and staffed in order to successfully undertake their missions. They need the ability to hire high quality professionals, including economists, accountants, lawyers, sophisticated risk management experts, and other persons with relevant expertise. Greater sophistication in our regulatory agencies is necessary in order to effectively regulate large, sophisticated, globally interconnected firms.

Conclusion

Recent challenges have strained the notion that U.S. markets are the most efficient, liquid and well-regulated markets in the world. They have highlighted the necessity of a fundamental review of our regulatory system in order to identify and correct its weaknesses. SIFMA strongly supports these efforts and commits to be a constructive participant in the process. We also recognize that the Committee is likely to consider other pressing financial markets issues as part of this review, including, among others, regulation of mortgage lending and financing institutions and the types of products they offer; addressing the problems of homeowners who are at risk of foreclosure; implementing the EESA; Securities Investor Protection Corporation reform; the role and performance of credit rating agencies; and problems with securities settlement and payment systems. SIFMA stands ready to assist the Committee as it considers these and other important issues. We are confident that through our collective efforts, we have the capacity to emerge from this crisis with stronger and more modern regulatory oversight that will better prepare us for the challenges facing financial firms today and in the future.

TESTIMONY OF

JOEL SELIGMAN

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

REGULATORY RESTRUCTURING AND REFORM OF THE FINANCIAL SYSTEM

OCTOBER 21, 2008

ROOM 2128, RAYBURN OFFICE BUILDING

Chairman Frank, Ranking Member Bachus and members of the Committee, 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.

We have reached a moment of discontinuity in our federal and state system of financial regulation that will require a comprehensive reorganization. Not since the 1929-1933 period has there been a period of such crisis and such felt need for a fundamentally new approach to financial regulation.

The need for a fundamental restructuring of finance is based only in part on the current crisis in our housing and credit markets, the concomitant collapse of several leading investment and commercial banks and insurance companies and dramatic deterioration of our stock market indices. Quite aside from the current emergency, finance has fundamentally changed in recent decades while financial regulation has moved far more slowly:

- 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. Today a substantial majority of Americans own stock directly or indirectly through pension plans or mutual funds. 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.

- 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.

Against this backdrop, what lessons does history suggest for this Committee to consider as it begins to address the potential restructuring of our system of 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 will operate best when far more evidence is available. The creation of the Securities and Exchange Commission and the adoption of six federal securities laws between 1933 and 1940, for example, were preceded by the Stock Exchange Practices hearings of the Senate Banking Committee held between 1932 and 1934. The longevity of the financial regulatory system that Congress adopted in the New Deal period was the consequence of the thoughtfulness of the hearings and legislative reports that preceded legislation.

Second, I would strongly urge each house of Congress to create a Select Committee similar to that employed after September 11th to provide a focused and less contentious review of what should be done. The most difficult issues in discussing appropriate reform of our regulatory system become far more difficult when multiple Congressional committees with conflicting jurisdictions address overlapping issues. This is a time when it is important that all appropriate alternatives be considered, including consolidating regulatory agencies, creating new regulatory agencies and transferring jurisdiction. This type of review is far more likely to succeed before a single Select Committee, presumably including the chairs or appropriate representatives from the existing oversight committees.

Third, 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 it also means, for example, our historic system of state insurance regulation should be reexamined. 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.

Fourth, a particularly difficult issue to address will be the appropriate balance between the need for a single agency to address systemic risk and the advantages of expert specialized agencies. There is today an obvious and cogent case for the Federal Reserve System or the Department of Treasury to serve as a crisis manager to address issues of systemic risk including those related to firm capital and liquidity. But to move too rapidly to transform either agency into the sole or dominant federal financial regulator comes with enormous risks.

There are powerful advantages to the expertise a focused agency such as the Securities and Exchange Commission (SEC) historically has brought to financial regulation.

In 1934, there was a strong preference of those who sought the most effective federal securities regulation that the Federal Trade Commission, which initially enforced the Securities Act of 1933, remain the federal securities regulator.[1] The FTC in 1934 was very sympathetic to far-reaching securities regulation and included among its members James Landis who championed continuing the FTC as the federal securities regulator. Only later would Landis revise his view and come to believe that an agency like the SEC with a narrow jurisdiction had advantages in providing administrative expertise that an agency with a broad jurisdiction, like the FTC, did not.[2]

More recent experience amplifies this point. 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 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

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[1] Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance 100 (Aspen 3d ed. 2003).
[2] Id. at 97.

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.[3] 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 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,"[4] it is reasonable to assume that no one at the PCAOB has ever derogated improving audit quality.

This point should not be overstated. The narrower an agency's agenda, the less likely it will be to galvanize White House or Congressional support for its budget and administrative priorities. An expert specialized agency runs the risk of being lost in the alphabet of federal agencies, subject, like the SEC too often has been, to a boom and bust cycle of budgetary and legislative support with effective support most likely only in times of crisis.[5]

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 recent Blueprint for a Modernized Financial Regulatory Structure 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 might be.

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[3] 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).

[4] Seligman, supra n.1, at 116-117.

[5] Cf. William Cary, Politics and Regulatory Agencies (1967), including the observation that "government regulatory agencies are stepchildren whose custody is contested by both Congress and the Executive, but without much affection from either one… Without the cooperation of both Congress and the Executive, little constructive can be achieved. To reemphasize the point, an agency is literally helpless if either branch is uninterested or unwilling to lend support."

Let me highlight why these types of hearings are best done by Select Committees. The politics of Congress and the agencies themselves tend to fortify inertia. In the wake of the October 19, 1987 stock market crash, for example, the Report of the Presidential Task Force on Market Mechanisms argued that "the markets for stocks, stock index futures and stock options – are in fact one market" and accordingly "one agency must have the authority to coordinate a few but critical intermarket regulatory issues, monitor intermarket activities and mediate intermarket concerns."[6] The Report concluded that the Federal Reserve Board "is well qualified to fill the role of intermarket agency."[7]

Within one month, this proposal was effectively dead. Federal Reserve Board Chair Alan Greenspan testified that he "seriously [questioned] this recommendation":

> To be effective, an oversight authority must have considerable expertise in the market subject to regulation, something that the CFTC and SEC have developed over time. Moreover, were the Federal Reserve to be given a dominant role in securities market regulation there would be a presumption by many that the federal safety net applicable to depository institutions was being extended to these markets and the Federal Reserve stood ready to jump in whenever a securities firm or clearing corporation was in difficulty.[8]

Beyond the Federal Reserve Board's lack of enthusiasm, there were other fundamental reasons for then rejecting the single regulatory proposal as initially formulated. The intermarket coordinator could be criticized for being overgeneral. In effect, the coordinator would be expected to address three quite distinct tasks: (1) The liquidity of the banking system in making available credit to stock brokers, futures, commodities merchants and clearing agencies; (2) stock market-stock options-stock index futures coordination issues including circuit breaker mechanisms, information systems, market surveillance, and enforcement as well as planning for market emergencies; and (3) harmonizing margin requirements across markets.

The first task was already addressed by the Federal Reserve Board; the second and third might most easily have been addressed by consolidating in the SEC all financial futures then overseen by the CFTC that were part of what correctly had been labeled "one market." Indeed the SEC-CFTC relationship required a considerable degree of duplication of effort when the SEC reviewed petitions for approval before the CFTC and had led to protracted litigation to determine which agency had jurisdiction over various hybrid financial instruments. But this type of argument, though advanced by SEC Chair

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[6] Report of the Presidential Task Force on Market Mechanisms 55, 59 (1988).
[7] Id. at 69.
[8] Black Monday, The Stock Market Crash of October 19, 1987, Hearings before Senate Comm. on Banking, Hous. & Urban Affairs, 100th Cong., 2d Sess. 98-99 (1988).

David Ruder in 1988[9] among many others before and after,[10] did not receive serious Congressional consideration for the simple reason that the SEC and the CFTC were subject to separate Congressional oversight committees. The most likely way in which there can be a mature consideration of the wisdom of consolidation of the SEC and CFTC would be to vest in a single committee in each house of Congress oversight responsibility for all stocks, stock options, and financial futures (or all futures). Similarly, the most likely way there could be mature consideration of broader types of financial regulatory consolidation today would involve vesting in a single committee in each house of Congress oversight responsibility over all relevant financial agencies.

Let us suppose that questions of agency expertise could be effectively addressed through some form of agency consolidation and that Congressional oversight issues could be resolved. There would then remain the most significant consideration that will confront Congress when it seeks to restructure regulation. How should a new regulatory order be designed? No one seeks more regulation for the sake of regulation. The real challenge is how to design the wisest system of regulation.

Until quite recently, 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[11] or proposals to restrict private litigation as were made by several recent proponents.[12] A frequently expressed theme involves replacing detailed financial regulation with more principles-based regulation.[13]

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.

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[9] Ruder, October Recollections: The Future of the U.S. Securities Markets, a paper delivered before the Economics Club of Chicago (Oct 20, 1988).

[10] Recently, see Casey Hails Congress' Consideration of Possible SEC-CFTC Combination, 39 Sec. Reg. & L. Rep. 1657 (2007); SIFMA Advocates SEC-CFTC Merger under Treasury's Reg Reform Initiative, 39 id. 1840.

[11] SEC Advisory Committee on Smaller Public Companies, 87 SEC Dock. 1138 (2006)

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

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

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.[14]

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 by unexpected SRO or industry initiatives as was done in the late 1960s during the so-called back office crisis.[15]

To be sure, it is almost inconceivable that if Congress were writing on a clean slate that Congress would create our current system of financial regulation. This system involves five separate federal institutions that address depository institutions, 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 regulation of banking in each state. We are one of the few countries in the world that separately regulates 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.

The Federal Reserve Bank often has stepped up and played a lead role in crisis management. This occurred after the October 1987 Stock Market Crash and in several other subsequent events such as the 1990s Asia, Russian and Long Term Capital crises. But the Fed's role, as with the role of the Department of Treasury before the adoption of the Emergency Economic Stabilization Act of 2008, has been improvised and ad hoc.

To formalize one agency as unequivocally in charge during times of crisis seems wise. It 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.

But to create a single clear crisis manager 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

[14] Department of Treasury, Blueprint for a Modernized Financial Regulatory Structure 215-218 (Mar. 2008).

[15] Seligman, supra n.1, 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).

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 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…"

Consolidation of existing agencies wisely should be considered. But the case for consolidation is weakened if the Federal Reserve or Department of Treasury is unequivocally given the role of crisis manager.

Each proposed consolidation should be analyzed on its individual merits. It is likely that some of the proposed mergers will prove wiser than others.

Underlying any potential financial regulatory consolidation are pivotal policy questions such as:

What should be the fundamental purpose of new legislation? Should Congress seek a system that effectively addresses systemic risk, safety and solvency of intermediaries, investor or consumer protection or other overarching objectives? If there are multiple objectives, as is likely, how should they be harmonized?

How should Congress address such topics as coordination of inspection, examination, conduct or trading rules, enforcement or private rights of action? Should one approach be used in all financial industries or should the different underlying context of different industries justify different rules?

Should new financial regulators be part of the Executive Branch or be independent regulatory agencies? If they are independent regulatory agencies, should they follow the self-funding model of the Federal Reserve System or rely on annual budget review as we now do at the SEC and independent regulatory agencies generally?

Should the emphasis in a new financial regulatory order be on command and control to best avoid economic emergency or on depoliticization to ensure that all relevant views are considered by financial regulators before decisions are made?

How do we analyze the potentialities of new regulatory norms in an increasingly global economy?

What role should self-regulatory organizations such as FINRA play in a new system of financial regulation?

These and similar pivotal questions should inform the most consequential debate over financial regulation that we have experienced since the New Deal period. The answers are neither simple nor obvious, but one conclusion is inevitable: How well we develop the structure of financial regulation will help determine this nation's financial stability for decades to come.

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. The problems were predicted, and the still unfolding consequences are largely predictable. 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 life time 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. The private sector has already shed a million jobs (net) this year. We as a country will be less able to provide for any future contingency. The strength of our country depends on the strength of our economy. We have not only what are euphemistically called impaired mortgages, we have an impaired economy.

Behind this impaired economy are not just sub-prime mortgages, but, in the words of Professor Nouriel Roubini, a sub-prime financial sector. And part of the reason that it has performed so poorly is inadequate regulations and inadequate 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. Later, there will be time to address these longer-run problems.

That view is wrong. The time to fix the regulatory problems is now, and that is why I especially congratulate you on holding these hearings.

Everybody agrees that a 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 simply given them more money to lend recklessly. We have changed neither the regulatory structures, the incentive systems, nor even those who are running these institutions—and who have demonstrated their inability to manage risk. As we taxpayers are pouring money into these banks, we have even allowed them to pour out money to their shareholders—who failed to exercise oversight over their executives.

To continue with the metaphor: 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.

This morning I want to describe briefly the principles, objectives, and instruments of a 21st century regulatory structure. Before doing so, I want to make two other prefatory remarks. The first is that reform of financial regulation must begin with a broader reform of corporate governance. Part of the problem is distorted incentive structures, including extensive use of stock options, which led to excessively short-sighted behavior and excessive risk taking. I have explained elsewhere how stock options provide incentives for bad accounting—of the kind that we have seen—moving activity off balance sheet. When Congress addressed the problems exposed in the Enron/Worldcom scandals, it didn't do anything about adequate disclosure of stock options. We need to correct that mistake, and to ask, more broadly, why is it that so many banks have employed incentive structures that have served stakeholders—other than the executives—so poorly?

The second remark is to renew the call to do something about the homeowners who are losing their homes and about our economy which is going deeper into recession. We cannot rely on trickle down economics—throwing even trillions at financial markets is not enough to save our economy. We need a package simply to stop things from getting worse, and a package to begin the recovery. We are giving a massive blood transfusion to a patient who is hemorrhaging from internal bleeding—but we are doing almost nothing to stop that internal bleeding.

We need a comprehensive recovery program. Given the mountain of debt accumulated over the past four years, there must be big bang for the buck—we must be sure that every dollar spent provides effective stimulus to the economy. And finally, the spending must be consistent with our vision of the future—we should seize this as an opportunity to undertake long postponed investments in education, technology, and infrastructure. Such spending can help transform our economy into the "green technology" of the future and help make us more competitive. We can strengthen our economy in the short run while at the same time promote long-term growth.

(Regrettably, the February stimulus package was too little, too late, and badly designed. It is no surprise that it did not work as its advocates hoped, and what limited effects it had were swamped by the subsequent increase in oil prices. Given the high level of household debt and the high level of insecurity, it is not surprising that large fractions of the money were saved or used to repay debt. This put households in a better position—but did not stimulate the economy. Besides, the problem with America is not that we consume too little, but too much; the rebates were designed to encourage that consumption binge, postponing the inevitable adjustment to some date in the future. By contrast, increased/extended unemployment benefits—with health care benefits to those who lose their jobs, critically important in our system where health insurance is employer provided—would have stimulated the economy far more in the short run, and increased infrastructure spending would have provided the basis for far stronger long-term growth.)

Some General Principles

We must begin with an understanding of the role of financial markets in our economy. 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 perform certain vital functions which enable the real economy to be more productive, including mobilizing savings, allocating capital, and managing risk, transferring it from those less able to bear it to those more able. In America, and some other countries, 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, evidence that the problems are systemic and systematic. And failures in financial markets have effects that spread out to the entire economy.

We thus have to understand why markets have failed so badly and what can be done about these failures. 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 in the US and some of the other advanced industrial countries 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.

The success of a market economy requires not just good incentive systems but good information—transparency. (This is, of course, the subject of the research for which I was awarded the Nobel Memorial Prize.) But there are often incentives, especially in managerial capitalism (where there is a separation of ownership and control), for a lack of transparency. Problems of lack of transparency are pervasive in financial markets, and those in financial markets have resisted improvements, such as more transparent disclosure of the costs of stock options. Stock options in return have provided incentives for accounting that increases reported profits—incentives for distorted and less transparent accounting. For instance, they put liabilities off-balance sheet, making it difficult to assess accurately their net worth.

Some of the "innovations" in the market, e.g. securitization and derivatives, in recent years have made these problems worse. Securitization has created new asymmetries of information. In the old days, those originating mortgages held on to them; banks knew the families to whom they had lent money. When there was a problem in repayment, they could understand its nature and work with the family on a payment plan. It was in everyone's interest for the family not to be thrown out into the street. Securitization was based on the premise that a "fool was born every minute." Globalization meant that there was a global landscape on which they could search for those fools—and they found them everywhere. Mortgage originators didn't have to ask, is this a good loan, but only, is this a mortgage I can somehow pass on to others.

Our financial markets have not only exploited these information asymmetries, but they have often also exploited the uninformed and the poorly educated. This is part of the reason for the need for strong consumer and investor protection. It is not a surprise that the problems first occurred in the sub-prime market, among less educated and lower income individuals. There was extensive predatory lending, and financial markets resisted laws restricted these abusive practices.

There is a third element of well-function markets—competition. But information imperfections often limit the extent of competition. In many markets, small and medium size businesses have access to only one or two lenders. That is part of the reason that bank failures are of such a concern: as the bank fails, information about credit worthiness held within these institutions is destroyed, and it will take time to recreate. In the meanwhile, access to credit may be limited.

America's financial markets have gone beyond these natural limitations of competition to engage in anti-competitive practices, especially in the area of credit cards. To be sure, the huge fees have helped absorb the losses from their bad lending practices, but the fact that the profits are so huge should be a signal that the market has not been working well.

In this case, the failure to have strong competition enforcement has had another consequence: we have "discovered" that there are a number of institutions that are so large that they are too big too fail. We, and they, knew that before; we, and they, knew what that implied: it 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, because we simply couldn't let them fail.

Even Adam Smith recognized that unregulated markets will try to restrict competition, and without strong competition markets will not be efficient. More recent research has shown that markets often fail to produce efficient outcomes (let alone fair or socially just outcomes) when information is imperfect or asymmetric—but information imperfections and asymmetries are at the center of financial markets. That is what they are about. Our financial markets have even worked hard to exacerbate these problems; as we have noted, they created non-transparent products that were so complex that not even those who created them fully understood the risks to which they gave rise.

And we should be clear—this non-transparency is a key part of the credit crisis that we have experienced over recent weeks.

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. When, a hundred years ago, Upton Sinclair depicted graphically America's stockyards and there was a revulsion against consuming meat, the industry turned to government for regulation and to assure consumers that meat was safe for consumption. In the same way, regulatory reform would help restore confidence in our financial markets.

Government regulation is especially important because inevitably, when the problems are serious enough, there will be bail-outs. Bail-outs have been a pervasive aspect of modern financial capitalism. Financial markets have repeatedly mismanaged risk, at a great cost to taxpayers and society. This is only the latest and biggest of the bail-outs that have become a regular feature of our peculiar kind of capitalism. We had the S & L bailout and the host of bail-outs from Mexico to Argentina. And we should be clear, while they are labeled with the name of the country where they occurred, they have been Wall Street bail-outs. American investors received back all or most of their money from bad loans, while the taxpayers of these poor countries had to pay.

Government is, implicitly or explicitly, providing insurance. And all insurance companies need to make sure that either the premia they charge for the risks are commensurate with size of the risks, or that the insured do not take actions which increase the likelihood of the insured against event occurring.

Some have suggested: shouldn't depositors exercise due diligence over where they put their money, and if they do that, won't that solve the problem? Furthermore, some have argued that providing guarantees to depositors creates moral hazard. The argument that providing such deposit insurance gives rise to moral hazard is absurd. How can ordinary citizens monitor the banks when the rating agencies and government regulators with their teams of auditors have shown themselves not up to the task? When the banks admit that they don't know their own balance sheet and know that they don't know that of other banks to whom they might lend? That is the reason for the cessation of lending on the interbank market. Monitoring is, to use the technical term, a public good: we all benefit if it is known that a bank is in sound financial position, and like any public good, it should be publicly provided. (There is, of course, another argument, for deposit insurance: Without such deposit insurance there can be runs on the banking system. These arguments make it clear that there should not be limits on deposit insurance.[1])

Regulations for the Twenty-first century

So far, I have tried to explain why we need regulations. Regulations are required 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)

[1] The irony is that typically, all depositors do get protected. But large depositors benefit, because they have not had to pay the full deposit insurance premium.

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.

In thinking about a new regulatory structure for the twenty-first century, we need to begin by observing that there are important distinctions between financial institutions that are central to the functioning of the economy system, whose failure would jeopardize the functioning of the economy and who are entrusted with the care of ordinary citizens' money, and those that provide investment services to the very wealthy. The former includes commercial banks and pension funds. These institutions must be heavily regulated in order to protect our economic system and the individuals whose money they are supposed to be taking care of. Consenting adults should be allowed to do what they like, so long as they do not hurt others. There needs to be a strong ring-fencing of these core financial institutions—they cannot lend money to or purchase products from less highly regulated parts of our financial system, unless such products have been individual approved by a Financial Products Safety Commission. (In the subsequent discussion, we will refer to these financial institutions as highly regulated financial entities.)

The fact that two investment banks have converted themselves into bank holding companies should be a source of worry. They argued that this would provide them a more stable source of finance. But they should not be able to use insured deposits to finance their risky activities. Evidently, they thought they could. It means that either prudential regulation of commercial banks has been so weakened that there is little difference between the two or that they believe that they can use depositor funds in their riskier activities. Neither interpretation is comforting.

Part of the agenda of ring-fencing—one which would have other side-benefits—is to restrict banks' dealing with criminals, unregulated and non-transparent hedge funds, and off-shore banks that do not conform to regulatory and accounting standards of our highly regulation financial entities and which have systematically been used for tax evasion, money laundering, and facilitating and encouraging drug dealing and corruption. Not doing so exposes our entire financial system to unwarranted risks. We have shown that we can do this when we want, when terrorism is the issue. But the safety and soundness of our financial system is also an important social objective. Without our connivance, for instance, these secret off-shore banks could not and would not survive.

Before describing the elements of a good regulatory structure, there are three other prefatory remarks.

First, there are always going to be asymmetries between regulators and the regulated—the regulated are likely to be better paid, and there are important asymmetries of information. But that does not mean that there cannot be effective regulation. The pay and skills of those innovating new drugs may be different from those that test their safety and efficacy; yet no one would suggest that such testing is either infeasible or undesirable. *But well-designed regulatory structures take into account those asymmetries—some regulations are easier to implement and more difficult to circumvent.*

There is always going to be some circumvention of regulations. However, that doesn't mean that one should abandon regulations. *A leaky umbrella may still provide some protection on a rainy day. No one would suggest that because tax laws are often circumvented, we should abandon them. Yet, one of the arguments for the repeal of Glass-Steagall was that it was, in effect, being circumvented. The response should have been to focus on the reasons that the law was passed in the first place, and to see whether those objectives, if still valid, could be achieved in a more effective way.*

This does mean, though, that one has to be very sensitive in the design of regulations. Simple regulations may be more effective, and more enforceable, than more complicated regulations. Regulations that affect incentives may be more effective, and more enforceable, than regulations directed at the behaviors themselves.

It also means that regulations have to constantly change, both to keep up with changes in the external environment and to keep up with innovations in regulatory arbitrage.

Moreover, as we think of regulatory systems, we have to think both about constraints and incentives—the imposition of constraints to stop certain activities, or the provision of incentives to encourage financial institutions not to do certain things, e.g. undertake excessive leverage.

Key elements of a regulatory structure

Transparency

Discussions of regulation must begin with transparency and disclosure. America prided itself on having transparent financial markets, criticizing others (such as those in East Asia) for their failures. It has turned out that that is not the case. We need improved transparency and disclosure, in a form that is understandable to most investors.

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. 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). There is a cost (presumably tailor-made products can be designed to better fit the needs of the purchasers), but the costs are less than the benefits—especially since there is evidence that in many cases there was less tailoring than there should have been.

Transparency regulation is, in fact, more complicated than often seems the case. Various aspects of the transparency agenda have long been opposed by those in the industry, and in some places, there are moves afoot to reduce transparency. For instance, some years ago, there was resistance by those in the financial industry to the introduction of more transparent and better auctions as a way of selling Treasury bills—for the obvious reasons. More recently, there was resistance to requirements for more transparent disclosure of the costs of stock options. Companies often do not report other aspects of executive compensation in a transparent way and typically do not disclose the extent to which executive compensation is correlated with performance. (Too often, when stock performance is poor, stock options are replaced with other forms of compensation, so that there is in effect little real incentive pay.) As I have noted, stock options provide incentives for corporate executives to provide distorted information. This may have played an important role in the current financial crisis. At the very least, there should be a requirement for more transparent disclosure of stock options.

Mark-to-market accounting was supposed to provide better information to investors about a bank's economic position. But now, there is a concern that this information may contribute to exacerbating the downturn. While financial markets used to boast about the importance of the "price discovery function" performed by markets, they now claim that market prices sometimes do not provide good information, and using transactional prices may provide a distorted picture of a bank's economic position. The problem is only partially with mark-to-market accounting; it also has to do with the regulatory system, which requires the provision of more capital when the value of assets is written down. Not using mark-to-market not only provides opportunities for gaming (selling assets that have increased in value while retaining those that have decreased, so that they are valued at purchase price), but it also provides incentives for excessive risk taking. Realizing that there is no perfect information system, it may be desirable to have both sets of information provided. But at the very least, we should not abandon mark-to-market accounting. Doing so would undermine confidence in our markets.

Part of improving transparency is to restrict—eliminate—off balance sheet transactions.

There also needs to be clear disclosure of conflicts of interest, and if possible, they should be restricted.

Regulating incentives

Although transparency and disclosure have been at the center of those calling for better regulation, it does not suffice. There are several other critical aspects of a good regulatory regime.

Regulating incentives is essential. The current system encourages excessive risk taking, a focus on the short term, and bad accounting practices.

Regulating incentives of managers is, as I have already noted, a key part of this agenda, including passing regulations that move us away from rewarding executives through stock options. Any incentive pay should be long-term—or least longer term than the current horizon. Bonuses should be based on performance over at least a five year period. If part of compensation is based on shorter term performance, there need to be strong clawback provisions. Any incentive pay system should not induce excessive risk taking, so that there should be limited asymmetries in the treatment of gains and losses. Any pay system that is claimed to be incentive-based should be demonstrably so. Average compensation and compensation of individual managers should be shown to be related to performance.

But there are at least three other system reforms. First, those who originate mortgages or other financial products should bear some of the consequences for failed products. There should be a requirement that mortgage originators retain at least a 20% equity share.

Secondly, it is clearly problematic for rating agencies to be paid by those that they rate and to sell consulting services on how ratings can be improved. Yet it is not obvious how to design alternative arrangements, which is why in many sectors inspections are publicly provided (such as the Food and Drug Administration). Competition among rating agencies can have perverse incentives—a race to the bottom. At the very least, rating agencies need to be more highly regulated. A government rating agency should be established.

Thirdly, we need to reduce the scope for conflicts of interest. Instead, they have expanded, e.g. by the repeal of the Glass-Steagall Act. (The effects were evident in the Worldcom and Enron scandals. The repeal had another unintended effect, more evident in the current crisis: the culture of risk taking that characterizes investment banks but is so inappropriate for commercial banks came to dominate.) But the sector is rife with conflicts of interest—there is, for instance, a clear conflict of interest when a mortgage originator also owns the company that appraises house values. This should be forbidden.

Curbing exploitive practices

Exploitive practices of the financial sector need to be curbed. The financial sector realized that there was money at the bottom of the pyramid, and they moved with all speed to ensure that it moved to the top. The exploitive practices include pay-day loans, predatory lending, and rent-a-furniture and similar scams. There needs to be a usury law (and this also applies to credit cards) limiting the effective rate of interest paid by users of the financial facility.

Curbing risky practices

Risky practices of the financial sector also need to be curbed. The worst practices were those that were simultaneously exploitive and risky—loans beyond people's ability to pay, involving repeated refinancing which generates large transactions costs. Many of these people, when they lose their home, they lose their life savings at the same time.

In the mortgage sector, variable rate mortgages in which payments can vary significantly (as opposed to variations in maturity) should be forbidden, at least for all individuals whose income is below a certain threshold. Practices which result in excessive transaction costs (entailing frequent refinancing of loans or mortgages) should be proscribed.

A simple regulation would have prevented a large fraction of the crises around the world—speed limits restricting the rate at which banks can expand, say, their portfolio of loans. Very rapid rates of expansion are typically a sign of inadequate screening. As we noted earlier, there are seldom hundred dollar bills lying on the ground. There was a reason that banks in the past did not make loans that exceeded 90% of the value of the collateral. There was a reason that banks required documentation.

There are several alternatives to speed limits imposed on the rate of expansion of assets: Increased capital requirements, increased provisioning requirements, and/or increased premia on deposit insurance for banks that increase their lending (lending in any particular category) at an excessive rate can provide incentives to discourage such risky behavior.

We have already discussed the desirability of restrictions on derivatives as part of the transparency agenda. Such restrictions may, at the same time, be part of the "curbing excess risk taking agenda." Such products (particularly standardized products) can, in certain instances, be part of risk management, e.g. used to offset foreign exchange risk. But banks' involvement in these went beyond laying off risk. They were gambling, and that kind of activity should be restricted.

Excessive leverage has also played a big role in this (as in many other) financial crises. Commercial banks and similar institutions have to have adequate capital and provisioning of risks. But capital adequacy rules have to be carefully designed. Capital adequacy standards/provisions (reserves) have to be designed to be countercyclical. Otherwise, there is a risk that they will contribute to cyclical fluctuations. The decrease of asset values in a downturn can force cutbacks in lending, exacerbating the downturn; and in the boom, the asset price increases allow more lending. On both sides, cyclical fluctuations are amplified.

Many, looking for simple and simplistic rules, hoped that capital adequacy requirements would be all that was required—a minimal intervention in the market by those believing in free markets but recognizing that free banking has been a disaster everywhere that it has been tried. Capital adequacy standards alone, however, do not suffice; indeed, increasing capital adequacy standards may lead to increased risk taking. Moreover, while government provision of capital may provide a buffer against bankruptcy, so long as management focuses on the returns to themselves and non-governmental shareholders, depending on the form of the provision of capital, risks of excessive risk taking may not be mitigated. Capital adequacy standards are not a substitute for close supervision of the lending and risk practices of banks. Banks will have an incentive to engage in regulatory and accounting arbitrage, and regulators must be alert to this possibility. They must have sufficient authority to proscribe such behavior. Bad lending practices may increase in cyclical downturns; this necessitates closer supervision at such times. Regulators also have to be particularly sensitive to the risks of increasing leverage in booms.

Regulators need to be aware of the risks posed by various practices within the financial system which contribute to risk and cyclicity (cyclical movements in leverage, pricing, and rating of rating agencies). These can be offset by countercyclical capital adequacy/provisioning requirements; cyclically adjusted limits on loan-to-value ratios and/or rules to adjust the values of collateral for cyclical price variations.

Better designed provision requirements may help stabilize the financial system. Banks should be required to make compulsory provisions for bond defaults. Banks should put up provisions (reserves) when loans are disbursed rather than when repayments (or, rather the lack of repayments) are expected. Such arrangements will reduce the cyclical patterns that have long been a part of credit market behavior.

Regulatory Institutions

Part of the problems we have seen in our financial markets is the failure to fully use regulatory powers and to adequately enforce existing rules. Our regulatory institutions have failed us. The Fed had regulatory authority that it failed to exercise—until after it was too late, closing the barn door after the horses were out. It is not surprising: if government appoints as regulators those who do not believe in regulation, one is not likely to get strong enforcement.

It is clear that we need a reform of our regulatory structures. In the paragraphs below, I describe some of the general principles and make some remarks about specific institutional design.

The problems of enforcement mean that we have to design robust regulatory systems, where gaps in enforcement are transparent. Relatively simple regulatory systems may be easier to implement and more robust. There needs to be sensitivity to the risk of regulatory capture. It may also be optimal to have duplicative regulatory systems: the costs of a mistake overwhelm the extra costs of regulation. And one must guard against regulatory competition—allowing a choice of regulators, which can lead to a race to the bottom.

Regulatory capture is not just a matter of "buying" regulators, or even of "revolving doors," but also of the capture of ideas and mindsets. If those who are supposed to regulate the financial markets approach the problem from financial markets' perspectives, they will not provide an adequate check and balance. But much of the inadequacy of current regulations and regulatory structures is the result of financial markets' political influence, in many countries through campaign contributions. These deeper political reforms, including campaign finance reform, are an essential part of any successful regulatory reform.

The regulatory system needs to be comprehensive; otherwise funds will flow through the least regulated 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.

That is why there is a need for a *financial markets stability commission*, having oversight of the entire financial system and providing integrated regulation of each of the parts of the system.

Such a commission would also look carefully at the interrelations among the parts of the system. Modern financial markets are complex, with complex interrelations among different institutions of different kinds, evidenced in the current crisis. A Financial Markets Stability Commission (FMSC) would assess over-all risks, looking at the functioning of the entire financial system and how it would respond to various kinds of shocks; in contrast, the Financial Products Safety Commission (discussed more fully below) would look at individual products and judge their appropriateness for particular classes of purchasers. Such a Commission should have identified, for instance, the risk posed by the breaking of the housing bubble. All of the regulatory authorities (those regulating securities, insurance, and banking) should report to the FMSC. We have seen how all financial institutions are interconnected and how an insurance firm became a systemic player. Similar functions can be performed by different kinds of institutions. There also needs to be oversight over the entire system to avoid regulatory arbitrage.

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 incentives 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.

In designing regulatory structure, there is another point that is critical: There are large distributional consequences of financial policies (both macro-economic and regulatory). They cannot be delegated to technocrats but are an essential part of the political process.

While the economy needs a well-functioning financial system, what is in the interest of financial markets may not be in the interest of workers or small businesses. There are trade-offs. For instance, the Fed's responsibility is not to maximize the well-being of financial markets; their mandate is broader. It is important that those broader interests be better reflected in institutional design.

The Fed is too closely connected with financial markets to be the sole regulator. Some worry about the cost of duplication. But when we compare the cost of duplication to the cost of damage from inadequate regulation—not just the cost to the taxpayer of the bail-outs but also the costs to the economy from the fact that we will be performing well below our potential—it is clear that there is no comparison. But in its role in ensuring economic stability, the Fed will have to be one of the regulators. The Fed has performed abysmally. Not only did it not do what it should have done to prevent the crisis, but it arguably contributed to the crisis. And it has not had an exactly steady hand in responding to the unfolding events.

Part of the reason for the Fed's failure is that it has focused excessively on price stability—though to be sure, the mandate that we give the Fed (inflation, growth and employment) has resulted in a broader focus than in many other countries. The role of the Fed is not just to maintain price stability but to promote growth and high employment. It seemed to think that maintaining low inflation/stable prices was necessary and almost sufficient for economic stability and growth. But in fact, a single-minded focus on price stability may actually lead to greater economic instability, which requires a sound financial system. The Fed and central bankers around the world were focusing on second order inefficiencies associated with low inflation, as problems of financial market instability grew—with the resulting real loss of output and economic inefficiency that were so much larger.

Part of a new regulatory structure for the twenty first century should be a *Financial Products Safety Commission*. This would assess the risks of particular products and determine their suitability for particular users. Many of these products were allegedly designed for managing particular risks, but the people buying those products did not face the risks for which they were designed. They thus increased the overall risks which they faced. There should be a presumption that financial markets work fairly well, and as a result there are no free lunches to be had. Financial innovations that are defended as reducing transactions costs, but instead lead to increased fees for financial institutions, should be suspect. The Financial Products Safety Commission would also look at the pricing of these products. Many new financial products (derivatives) were sold as lowering transactions costs and providing new risk arbitrage opportunities, but pricing was based on information provided by existing assets, and they succeeded in generating huge fees.

Concluding comments

I want to conclude my remarks by returning to my original theme—we need to make our financial system work better. That will require more than just the reforms of financial market regulations and regulatory structures.

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 regulation 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. Earlier, I talked about the need for reforming corporate governance and stronger and more effectively enforced anti-trust laws. Our tax laws too have played a role in the current debacle. In spite of the new complexities resulting from the so-called innovation, this financial crisis is similar to many in the past—there has been excessive leverage. Tax laws encouraged leveraging. For this and other reasons we need to rethink the preferential treatment given to capital 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, that they won't be cheated. In the past, one of the reasons that capital flowed to the U.S. was because they believed our financial markets were well-regulated and that they 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 show 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.

Finally, I want to address the question: will regulation, of the kind I have suggested, stifle innovation? I would argue that, to the contrary, it may encourage *real* innovation. The fact of the matter is that most of our financial market's creativity was directed to circumventing regulations through creative accounting so that no one, not even the banks, knew their financial position, and tax arbitrage. 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—and indeed, have resisted many of the innovations which would have increased the efficiency of our economy. Elsewhere, there has been real innovation—the Danish mortgage market is an excellent example, with low transaction costs and much greater security. To be sure, within America's financial sector, there have been important innovations, like venture capital firms. But this represents a small part of our financial sector, and today this innovative sector may be facing difficulties, another part of the collateral damage from the misdeeds of the rest of the financial sector. By restricting the scope for the kinds of "innovations" that have contributed not to economic growth but to economic instability—the liar loans, the financial alchemy that purported to be able to convert F rated sub-prime mortgages into products safe enough to be held by commercial banks or pension funds—hopefully this creative energy will be diverted to more constructive uses.

Good financial institutions are essential to a well-performing economy. Our financial institutions have failed us, with the predictable and predicted consequences. Part of the reason is inadequate regulations and regulatory structures. We can, we must do better, much better than we have in the past.

INDEPENDENT COMMUNITY
BANKERS *of* AMERICA

Testimony of

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On behalf of the

Independent Community Bankers of America

Before the

Congress of the United States
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"Financial Restructuring and Reform"

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Mr. Chairman, Ranking Member Bachus, members of the Committee, my name is Michael Washburn, and I am President and CEO of Red Mountain Bank, a $351 million community bank in Hoover, Alabama. I serve on the Board of Directors of the Independent Community Bankers of America[1] (ICBA), and I'm Vice Chairman of ICBA's Policy Development Committee. I am pleased to have this opportunity to testify today on the issue of regulatory restructuring and reform of the financial system.

As this nation continues to struggle with the worst financial collapse since the Great Depression, many Americans are losing confidence in our financial system and questioning our resiliency. I am pleased to report, Mr. Chairman, that the one segment of the financial system that is working and working well is the community banking sector. We are open for business, we are making loans, and we are ready to help all Americans weather these difficult times.

State of Community Banking is Strong

Community banks are strong, commonsense lenders that largely did not engage in the practices that led to the current crisis. Most community banks take the prudent approach of providing loans that customers can repay, which best serves both banks and customers. As a result of this commonsense approach to banking, the community banking industry, in general, is well-capitalized and has fewer problem assets than other segments of the financial services industry.

That is not to suggest that community banks are unaffected by the recent financial collapse. Indeed, the squeeze on interbank lending has raised liquidity issues in some areas, the collapse in the value of the preferred stock of government-sponsored enterprises Fannie Mae and Freddie Mac under the Treasury/Federal Housing Finance Agency conservatorship has affected the bottom lines of some community banks, and the general decline in the economy has caused many consumers to tighten their belts and reduce the demand for credit.

But overall, the state of the community banking industry is strong, and we are confident that this nation's economic fortunes will recover and its economy will regain its resiliency.

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[1] *The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 268,000 Americans, ICBA members hold more than $908 billion in assets, $726 billion in deposits, and more than $619 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

Right now, however, we are still in financial crisis. These historic times call for level-headed, deliberative and constructive thinking to map a course of action for the future so we never have to go through this again. I congratulate you, Mr. Chairman and Ranking Member Bachus, for initiating this important and difficult process today.

For over three generations, the U.S. banking regulatory structure has served this nation well. Our banking sector has been the envy of the world and is the strongest and most resilient financial system the world has ever known. However, as has become evident, **non-bank financial regulation has been lax**, especially regarding capital adequacy and risk management, leaving wide gaps that must be closed to ensure the future stability of the entire financial system.

Congress Must Address Excessive Concentration

The current crisis has made it painfully obvious that the financial system has become too concentrated, and – for many institutions – too loosely regulated. The doctrine of too big – or too interconnected – to fail, has finally come home to roost, to the detriment of American taxpayers.

Federal Reserve Chairman Bernanke acknowledged such when he said following a recent New York speech: *"We need to have that local knowledge that is incorporated in local lending, local community banking. If we have oversight, if we strengthen the system so that it's less prone to be damaged by the failure of one firm, and if we develop a resolution regime, I think we will at least get our hands around the too-big-to-fail problem."*

Unfortunately, government interventions necessitated by the too-big-to-fail policy have exacerbated rather than abated the long-term problems in our financial structure. Through Federal Reserve and Treasury orchestrated mergers, acquisitions and closures, the big have become bigger. Today, the four largest banking companies in the U.S. control more than 40 percent of the nation's deposits and more than 50 percent of its assets. It is ICBA's view that putting such excessive and concentrated power in the hands of just four banking executives is dangerous and unhealthy.

Congress should seriously debate whether it is in the public interest to have so much power and concentrated wealth in the hands of so few and adopt effective remedies. ICBA would suggest that downsizing these super mega sized institutions should be under consideration.

Emergency Measures Have Been Essential

While painful to us, ICBA was a strong supporter of the Emergency Economic Stabilization Act of 2008 because community banks recognized that a freeze in the credit markets would affect not only Wall Street, but Main Street as well. Doing nothing was not an option. Still, it is unfortunate that circumstances required that this legislation had to be completed on such an urgent basis, leaving little opportunity for alternative plans to be fully aired and vigorously debated.

We are very grateful to you, Chairman Frank, and to you, Ranking Member Bachus, for your energetic support for including the concerns of community banks in this legislation. Because of your leadership, Congress recognized the threat to the community banking sector and inserted measures to mitigate these threats, such as tax relief for community bank holders of GSE preferred stock, limiting the guarantee for money market mutual funds, and ensuring community bank access to the Troubled Asset Relief Program.

Bank Regulatory Structure is Effective

As you consider a new regulatory model, it would make sense to look at one that has worked rather than just try to fix one that has failed. The community banking model, with decentralized resources, local decision making, and geographically diversified assets has worked well and has to date endured a devastating economic blow not of its making.

Can we construct a regulatory and supervisory model that is better than the one we have? With proper thought and consideration very possibly we can. But the current system should not be summarily scrapped in the zeal for reform. Troubled times call for cool heads and measured responses. Let us learn the lessons of history and not repeat the rush to legislate that are the marks of Sarbanes Oxley, the Patriot Act, and other bills written during crises that pushed the pendulum too far off center.

These Parts of Current System Worth Preserving

For starters, let's look at what is good about the current regulatory system:

- *ICBA Supports Multiple Federal Banking Regulators.* Having more than a single federal agency regulating depository institutions provides valuable regulatory checks-and-balances and promotes "best practices" among those agencies – much like having multiple branches of government. The collaboration that is required by multiple federal agencies on each interagency regulation insures that all perspectives and interests are represented, that no one type of institution will benefit over another, and that the resulting regulatory or supervisory product is superior.

A monolithic federal regulator such as the U.K.'s Financial Service Authority would be dangerous and unwise in a country with a financial services sector as diverse as the United States, with tens of thousands of banks and other financial services providers. Efficiency must be balanced against good public policy. With the enormous power of bank regulators and the critical role of banks in the health and vitality of the national economy, it is imperative that the bank regulatory system **preserves real choice, and preserves both state and federal regulation.**

- *ICBA Supports a Dual Banking System.* ICBA believes strongly in the dual banking system. Having multiple charter options -- both federal and state -- that financial institutions can choose from is essential for maintaining an innovative and resilient regulatory system. The dual banking system has served our nation well for nearly one hundred and fifty years. While the lines of distinction between state and federally chartered banks have blurred in the last twenty years, community banks continue to value the productive tension between state and federal regulators. One of the distinct advantages to the current dual banking system is that it ensures community banks have a choice of charters and the supervisory authority that oversees its operations. **In many cases over the years the system of state regulation has worked better than their federal counterparts. State regulators bring a wealth of local market knowledge and state and regional insight to their examinations of the banks they supervise, particularly in the area of consumer regulation.**

- *All Commercial Banks, Both Federal and State Chartered, Should Have Access to FDIC Deposit Insurance.* Deposit insurance as an explicit government guarantee has been the stabilizing force of our nation's banking system for seventy-five years. It promotes confidence by providing safe and secure depositories for small businesses and individuals alike. **All commercial banks, both federal and state chartered, should have access to FDIC deposit insurance.**

The banking industry has fully funded the FDIC for its entire existence. No insured depositor has ever lost any money. As part of its emergency response to the current crisis, the Treasury instituted a temporary guarantee fund for money market mutual funds. In many ways, this product is superior to FDIC insurance. The government must not continue to offer a superior product through MMMFs that unfairly competes against FDIC-insured banks. Again, we are pleased that the Congress made clear that this must be a temporary program and that Treasury clarified that there are limits.

One of the unfortunate realities of our current system is that the policy of too-big-to-fail creates two classes of uninsured depositors – those that have 100 percent de-facto coverage in too-big-to-fail banks and those who stand to lose money in too-small-to-save institutions. This leaves community banks at a distinct disadvantage in competing for deposits. The temporary increase in deposit insurance coverage mitigates this disadvantage temporarily, but it will return when the temporary increase expires.

- *The Current Federal Bank Regulatory Structure Provides Sufficient Protections for Consumer Customers of Depository Institutions.* One benefit of the current regulatory structure is that the federal banking agencies have coordinated their efforts and developed consistent approaches to enforcement of consumer regulations, both informally and formally, as they do through the Federal Financial Institutions Examination Council (FFIEC). This interagency cooperation has created a system that ensures a breadth of input and discussion that has produced a number of beneficial interagency guidelines, including guidelines on non-traditional mortgages and subprime lending, as well as overdraft protection, community reinvestment and other areas of concern to consumers.

Perhaps more important for consumer interests than interagency cooperation is the fact that depository institutions are closely supervised and regularly examined. This examination process ensures that consumer financial products and services offered by banks, savings associations and credit unions are regularly and carefully reviewed for compliance.

ICBA believes that non-bank providers of financial services, such as mortgage companies, mortgage brokers, etc., should be subject to greater oversight for consumer protection. For the most part, unscrupulous and in some cases illegal lending practices that led directly to the subprime housing crisis originated with non-bank mortgage providers. The incidence of abuse was much less pronounced in the highly regulated banking sector.

- *Ten Percent Deposit Concentration Cap Should be Maintained.* If this current crisis has taught us anything it is that past public polices have created a very dangerous overconcentration of financial resources in too few hands, to the point that just one failure of these Too Big Too Fail; and Too Big to Manage, and Too Big to Regulate financial institutions can destabilize the economy and well being of the United States. Public policy should promote a diversified economic and financial system upon which our nation's prosperity and consumer choice is built and not encourage further consolidation and concentration of the banking industry. Recent Treasury and Federal Reserve actions have led to large bank mergers and acquisitions and have had an adverse impact on consumers, small businesses and local communities. The ten percent deposit concentration cap adopted in the Riegle-Neal Banking and Branching Efficiency Act of 1994 should be maintained and strengthened.

- *ICBA Supports the Savings Institutions Charter and the OTS.* Savings institutions play an essential role in providing residential mortgage credit in the U.S. The thrift charter should not be eliminated and the Office of Thrift Supervision should not be merged into the Office of the Comptroller of the Currency. The OTS has expertise and proficiency in supervising those financial institutions that have made the choice to operate with a savings institution charter with a business focus on housing finance and other consumer lending.

- *Maintain GSEs Liquidity Role.* Many community bankers rely on Federal Home Loan Banks for liquidity and asset/liability management through the advance window. Red Mountain Bank places tremendous reliance upon our FLHB as a source of liquidity and our FHLB has been an important partner in the growth of our organization. We also have been able to provide mortgage services to our clients by selling mortgages to Fannie Mae and Freddie Mac.

ICBA strongly supported congressional efforts to strengthen the regulation of the housing GSEs to ensure the ongoing availability of these services. We urge the Congress to ensure these enterprises continue their vital services to the community banking industry in a way that protects taxpayers and ensures their long-term viability.

There are few "rules of the road" for the unprecedented government takeover of institutions the size of Fannie and Freddie, and the outcome is uncertain. Community banks are concerned that the ultimate disposition of the GSEs by the government may fundamentally alter the housing finance system in ways that disadvantage consumers and community bank mortgage lenders.

The GSEs have performed their task and served our nation very well. Their current challenges do not mean the mission they were created to serve is flawed. ICBA firmly believes the government must preserve the historic mission of the GSEs, that is, to provide capital and liquidity for mortgages to promote homeownership and affordable housing in both good times and bad.

Community banks need an impartial outlet in the secondary market such as Fannie and Freddie – one that doesn't compete with the community banks for their customers. Such an impartial outlet must be maintained. This is the only way to ensure community banks can fully serve their customers and their communities and to ensure their customers continue to have access to affordable credit.

As the future structure of the GSEs is considered, ICBA is concerned about the impact on their effectiveness of either an elimination of the implied government guarantee for their debt or limits on their asset portfolios. These are two extremely important issues. The implied government guarantee is necessary to maintain affordable 30-year, fixed rate mortgage loans. Flexible portfolio limits should be allowed so the GSEs can respond to market needs. Without an institutionalized mortgage-backed securities market such as the one Freddie and Fannie provide, mortgage capital will be less predictable and more expensive, and adjustable rate mortgages could become the standard loan for home buyers, as could higher down payment requirements.

- *Maintain and Strengthen the Separation of Banking and Commerce.* The long-standing policy prohibiting affiliations or combinations between banks and non-financial commercial firms (such as Wal-Mart and Home Depot) has served our nation well. **ICBA opposes any regulatory restructuring that would allow commercial entities to own a bank. If it is generally agreed that the current financial crisis is the worst crisis to strike the United States since the Great Depression, how much worse would this crisis have been had the retail commercial sector been intertwined as well? Regulators are unable to properly regulate the existing mega financial firms, how much worse would it be to attempt to regulate business combinations many times larger than those that exist today?**

This issue has become more prominent with recent Federal Reserve encouragement of greater equity investments by commercial companies in financial firms. This is a very dangerous path.

Mixing banking and commerce is bad public policy because it creates conflicts of interest, skews credit decisions, and produces dangerous concentrations of economic power. It raises serious safety and soundness concerns because the companies operate outside the consolidated supervisory framework Congress established for owners of insured banks. It exposes the bank to risks not normally associated with banking. And it extends the FDIC safety net putting taxpayers at greater risk. Mixing banking and commerce was at the core of a prolonged and painful recession in Japan.

Congress has voted on numerous occasions to close loopholes that permitted the mixing of banking and commerce, including the non-bank bank loophole in 1987 and the unitary thrift holding company loophole in 1999. However, the Industrial Loan Company loophole remains open.

ICBA greatly appreciates the leadership of both Chairman Frank and Ranking Member Bachus to close this loophole, a goal ICBA continues to pursue. Creating greater opportunities to widen this loophole would be a serious public policy mistake, potentially depriving local communities of capital, local ownership, and civic leadership.

Congress Can Improve the Regulatory System by Closing Regulatory Gaps and Promoting a Tiered Regulatory System

In addition to maintaining these fundamental tenets of our currently financial regulatory structure, we commend the following recommendations for your consideration:

- *Unregulated Institutions Must Now be Supervised.* In recent weeks and months the government has spent huge amounts of money dealing with the failures of institutions that it did not supervise, such as Bear Stearns and AIG. If the government now stands ready to spend money when these institutions fail, it must take effective steps to reduce the risk of failure and compensate the government – the taxpayers – if failures do occur. Like banks, these types of institutions should pay for this regulation and supervision.

These institutions must adhere to minimum capital requirements and management standards comparable to those imposed on FDIC-insured institutions. In addition, activities that go beyond the risk profile of FDIC-insured commercial banks, must be fully disclosed to investors and regulators.

Because the taxpayer is ultimately at risk for large financial institutions that are not FDIC-insured, the taxpayers must be compensated for the added regulatory costs they will incur and for the risks they take on. Therefore, systemic risk institutions must pay a systemic risk premium to cover these costs and risks.

- *Systemic Risk Institutions Should be Reduced in Size.* As we have witnessed recently, some financial institutions are too big or too interconnected to fail and therefore pose systemic risk not only to the Deposit Insurance Fund but to our nation's financial and economic system. Rescuing such institutions from failing has cost our nation dearly in treasure and in confidence. Allowing four companies to control more than 40 percent of our nation's deposits and more than 50 percent of our nation's banking assets is dangerous and unwise. Smaller institutions would pose a significantly smaller risk. ICBA believes these institutions should be split up or required by the government to divest themselves of enough assets so that they cease to pose a systemic risk to DIF and our economy.

- *ICBA Supports a Tiered Regulatory System.* ICBA supports a system of tiered regulation that subjects large, complex institutions that pose the highest risks to more rigorous supervision and regulation than less complex community banks. Large banks such as Bank of America or JP Morgan should be subject to continuous examination, more rigorous capital and other safety and soundness requirements, and should pay a "risk premium" in addition to their regular deposit insurance premiums to the FDIC than community banks in recognition of the size and complexity and the amount of risk they pose.

Community banks should be examined on a less intrusive schedule and should be subject to a more flexible set of safety and soundness restrictions in recognition of their less complex operations and the fact that community banks are not "systemic risk" institutions. Public policy should promote a diversified economic and financial system upon which our nation's prosperity and consumer choice is built and not encourage further consolidation and concentration of the banking industry by discouraging current community banking operations or new bank formation.

- *Suspend Mark-to-Market and Fair Value Accounting.* Our accounting system for financial assets requires institutions to publicly report the "market value" of their financial assets and, in some circumstances, record assets at those levels. This system can work when markets are functioning and "market values" are reflective of true economic value. However, now markets are overreacting and valuing many performing assets at irrational levels. If every institution must mark these assets at this "market" price which represents a liquidation value rather than a going concern value, they will become insolvent on an accounting basis alone. This would happen even if the assets are performing and retain actual economic value. Congress gave the SEC the power to suspend mark-to-market accounting to avoid this race to the bottom. SEC and FASB have, instead, reiterated prior guidance and allowed the mark-to-liquidations to continue. If the SEC will not act, Congress should direct it to do so.

Closing

Community banks play a vital role in the economic well being of countless individuals, neighborhoods, businesses, organizations and communities throughout the country. They are one of the key sources of credit and other financial services to small businesses, the most prolific job creating sector of our economy, accounting for more than a third of all commercial bank small business loans which is more than twice the community bank's share of total U.S. banking assets. It is vital to the economy that public policy promote the competitiveness and efficiency of community banks and support and encourage a diverse financial system. Meaningful regulatory restructuring that recognizes the differences between community banks and large, complex banking companies would go a longer way towards enhancing competitiveness of community banks and ensuring the continued vitality of community banking in the future.

Testimony of

Edward L. Yingling

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Committee on Financial Services

United States House of Representatives

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Before the

Committee on Financial Services

United States House of Representatives

October 21, 2008

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Comparable financial activities should be regulated in a similar manner.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Charter choice should be preserved.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

1. **The structure and process of FASB, including the process by which it makes decisions.** Although ABA has always appreciated the openness with which FASB has listened to our concerns and recommendations – as well as those of other interested parties – FASB does not follow any formal procedures to ensure transparency (such as the Administrative Procedures Act) nor does it ensure that the benefits outweigh the costs.
2. **The degree of oversight of the federal government.** The SEC has been content to leave the structure of that oversight vague and, in fact, has seldom intervened – at least publicly – on critical issues.
3. **Where oversight should be housed.** As a practical matter, the oversight structure will very much determine the outcome of the first two issues. The SEC, understandably, was given this oversight role originally because it regulated public company disclosures, and accurate financial reporting was central to the functioning of our capital markets. Now that it has become apparent that accounting rules can have deep economic and systemic effects, Congress should consider whether that authority properly rests within the SEC.

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

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

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

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

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

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

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

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

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

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

Conclusion

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

Appendix A:

Origins of the Current System

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

GLBA brought about the following changes, among others:

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

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

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

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

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

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

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

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

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

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

BARNEY FRANK, MA, CHAIRMAN

U.S. House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

SPENCER BACHUS, AL, RANKING MEMBER

October 14, 2008

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman Cox:

The Emergency Economic Stabilization Act of 2008 requires the Securities and Exchange Commission, in consultation with the Secretary of the Treasury and the Federal Reserve, to conduct a study of mark-to-market accounting applicable to financial institutions, including depository institutions, and submit a report to Congress with its findings and recommendations within 90 days. I am pleased that the Commission is devoting the necessary attention and resources to complete this study by January 2, 2009. It is my expectation that the Commission will present Congress with possible alternatives to amend or revise fair value accounting standards.

The pro-cyclical effects of fair value or "mark-to-market" accounting are widely acknowledged as a major contributor to the current crisis in our financial markets. It is also recognized that mark-to-market was a well-intentioned attempt to address the abuses of Enron, WorldCom and others. During the current crisis, many believe the negative consequences of applying fair value accounting principles in a market that is not functioning normally are greater than the benefits. The solution to this problem is not to abandon sound, consistent accounting conventions, but to adopt some middle way, some more balanced accounting standard.

The SEC's staff guidance issued last month reflects an understanding that some adjustment in the application of FAS 157 is an appropriate response to current conditions. Under the SEC interpretation, in the event of "forced" or "distressed" transactions, FAS 157 allows adjustments to asset values. The values assigned under this approach would be far from arbitrary. The holders of assets would be required to provide substantiation of the values assigned using actuarially sound assumptions of the determinable factors that indicate reasonably expected cash flow and total payoff.

It is urgent that action be taken on this matter immediately. The reduced values being placed on assets using the existing interpretation of FAS 157 threaten to offset the beneficial impact of the capital being injected into financial institutions by the government under the Emergency Economic Stabilization Act. For the sake of our economy and the health of our financial sector, that outcome must be avoided.

Sincerely,

Spencer Bachus

Spencer Bachus
Ranking Member

American Enterprise Institute for Public Policy Research

AEI

September 2008

Financial Services Outlook

The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac

By Peter J. Wallison and Charles W. Calomiris

The government takeover of Fannie Mae and Freddie Mac was necessary because of their massive losses on more than $1 trillion of subprime and Alt-A investments, almost all of which were added to their single-family book of business between 2005 and 2007. The most plausible explanation for the sudden adoption of this disastrous course—disastrous for them and for the U.S. financial markets—is their desire to continue to retain the support of Congress after their accounting scandals in 2003 and 2004 and the challenges to their business model that ensued. Although the strategy worked—Congress did not adopt strong government-sponsored enterprise (GSE) reform legislation until the Republicans demanded it as the price for Senate passage of a housing bill in July 2008—it led inevitably to the government takeover and the enormous junk loan losses still to come.

Now that the federal government has been required to take effective control of Fannie and Freddie and to decide their fate, it is important to understand the reasons for their financial collapse—what went wrong and why. In his statement on September 7 announcing the appointment of a conservator for the two enterprises, Treasury Secretary Henry M. Paulson pointed to their failed business models as the reason for their collapse. This was certainly a contributing element, but not the direct cause. The central problem was their dependence on Congress for continued political support in the wake of their accounting scandals in 2003 and 2004. To curry favor with Congress, they sought substantial increases in their support of affordable housing, primarily by investing in risky and substandard mortgages between 2005 and 2007.

As GSEs, Fannie and Freddie were serving two masters in two different ways. The first was an inherent conflict between their government mission and their private ownership. The government mission required them to keep mortgage interest rates low and to increase their support for affordable housing. Their shareholder ownership, however, required them to fight increases in their capital requirements and regulation that would raise their costs and reduce their risk-taking and profitability. But there were two other parties—Congress and the taxpayers—that also had a stake in the choices that Fannie and Freddie made. Congress got some benefits in the form of political support from the GSEs' ability to hold down mortgage rates, but it garnered even more political benefits from GSE support for affordable housing. The taxpayers got highly attenuated benefits from both affordable housing and lower mortgage rates but ultimately faced enormous liabilities associated with GSE risk-taking. This *Outlook* tells the disheartening story of how the GSEs sold out the taxpayers by taking huge risks on substandard mortgages, primarily to retain congressional support for the weak regulation and special benefits that fueled their high profits and profligate executive compensation. As if that were not enough, in the process, the GSEs' operations promoted a risky subprime mortgage binge in the United States that has caused a worldwide financial crisis.

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The peculiar structure of the GSEs—shareholder-owned companies with a public mission—reflected a serious confusion of purpose on the part of the Lyndon Johnson administration and the members of Congress who created this flawed structure in 1968. In seeking to reduce the budget deficits associated with the Vietnam War and Great Society programs, the administration hit upon the idea of "privatizing" Fannie Mae by allowing the company to sell shares to the public. This, according to the budget theories of the time, would take Fannie's expenditures off-budget, while allowing it to continue its activities with funds borrowed in the public credit markets. But turning Fannie into a wholly private company was not acceptable either. Various special provisions were placed in Fannie's congressional charter that intentionally blurred the line between a public instrumentality and a private corporation. Among these provisions: Fannie was given a line of credit at the Treasury; the president could appoint five members of its board of directors; and its debt could be used, like Treasury debt, to collateralize government deposits in private banks.

Fannie's congressional charter and its unusual ties to the government ensured that the market would recognize its status as a government instrumentality: that despite its private ownership, the company was performing a government mission. Because it was highly unlikely that the U.S. government would allow one of its instrumentalities to default on its obligations, Fannie was perceived in the capital markets to have at least an implicit government backing and was thus able to borrow funds at rates that were only slightly higher than those paid by the U.S. Treasury on its own debt offerings. In 1970, the Federal Home Loan Bank Board created Freddie Mac to assist federal savings and loan associations in marketing their mortgages; Freddie was also allowed to sell shares to the public in 1989 and became a competitor of Fannie Mae under a congressional charter that established an identical special relationship with the government.

The special relationship, codified by these unique charters, required the GSEs to pursue another inherently conflicted mission that pitted their shareholders against the taxpayers. To the extent that their government backing allowed the GSEs to take excessive financial risks, it was the taxpayers and not the shareholders who would ultimately bear the costs. That result—the privatization of profit and the socialization of risk—has now come to pass. U.S. taxpayers are now called upon to fill in the hole that reckless and improvident investment activity—fueled by inexpensive and easily accessible funds—has created in the GSEs' balance sheets. The special relationship was also the GSEs' undoing, because it allowed them to escape the market discipline—the wariness of lenders—that keeps corporate managements from taking unacceptable risks.

> The special relationship with Congress was the GSEs' undoing because it allowed them to escape the market discipline—the wariness of lenders—that keeps corporate managements from taking unacceptable risks.

Normally, when a privately held company is backed by the government (for example, in the case of commercial banks covered by the Federal Deposit Insurance Corporation), regulation is the way that the government protects the taxpayers against the loss of market discipline. When Fannie Mae was privatized in 1968, however, no special regulatory structure was created to limit the taxpayers' exposure to loss. The Johnson administration officials who structured the privatization may not have realized that they were creating what we recognize today as a huge moral hazard, but when Fannie became insolvent (the first time) in the high-interest-rate environment of the early 1980s, policymakers recognized that the company represented a potential risk to taxpayers.

In 1991, as Congress finally began the process of developing a regulatory regime for the GSEs, congressional interest in supporting affordable housing was growing. At this point, Fannie Mae initiated its first foray into affordable housing—a relatively small $10 billion program, probably intended to show Congress that the GSEs would support affordable housing without a statutory mandate. Nevertheless, Congress added an affordable housing "mission" to the GSE charters when it created their first full-time regulator, the Office of Federal Housing Enterprise Oversight (OFHEO). The new agency had only limited regulatory authority. It was also housed in the Department of Housing and Urban Development (HUD), which had no regulatory experience, and it was funded by congressional appropriations, allowing the GSEs to control their regulator through the key lawmakers who held OFHEO's purse strings.

The new affordable housing mission further increased the congressional policy stake in the GSEs, but it also initiated a destructive mutual dependency: Congress began to rely on Fannie and Freddie for political and financial support, and the two GSEs relied on Congress to protect their profitable special privileges. In later years, attention to the political interests of Congress became known at the GSEs as "management of political risk." In a speech to an investor conference in 1999, Franklin Raines, then Fannie's chairman, assured them that "[w]e manage our political risk with the same intensity that we manage our credit and interest rate risks."[1]

Benefits to Congress

Managing their political risk required the GSEs to offer Congress a generous benefits package. Campaign contributions were certainly one element. Between the 2000 and 2008 election cycles, the GSEs and their employees contributed more than $14.6 million to the campaign funds of dozens of senators and representatives, most of them on committees that were important to preserving the GSEs' privileges.[2] And Fannie knew how to "leverage" its giving, not just its assets; often it enlisted other groups that profited from the GSEs' activities—the securities industry, homebuilders, and realtors—to sponsor their own fundraising events for the GSEs' key congressional friends. In addition to campaign funds, the GSEs—Fannie Mae in particular—enhanced their power in Congress by setting up "partnership offices" in the districts and states of important lawmakers, often hiring the relatives of these lawmakers to staff the local offices. Their lobbying activities were legendary. Between 1998 and 2008, Fannie spent $79.5 million and Freddie spent $94.9 million on lobbying Congress, making them the twentieth and thirteenth biggest spenders, respectively, on lobbying fees during that period.[3] Not all of these expenditures were necessary to contact members of Congress; the GSEs routinely hired lobbyists simply to deprive their opponents of lobbying help. Since lobbyists are frequently part of lawmakers' networks—and are often former staffers for the same lawmakers—these lobbying expenditures also encouraged members of Congress to support Fannie and Freddie as a means of supplementing the income of their friends.

In the same vein, Fannie and Freddie hired dozens of Washington's movers and shakers—at spectacular levels of compensation—to sit on their boards, lobby Congress, and in general help them to manage their political risk. (An early account of this effort was an article entitled "Crony Capitalism: American Style" that appeared in *The International Economy* in 1999.[4] A later version of the same point was made in *Investor's Business Daily* nine years later.[5]) The GSEs also paid for academic research to assure the public that the GSE mission was worthwhile and that the GSEs posed minimal risks to taxpayers. For example, Nobel laureate Joseph Stiglitz coauthored an article in 2002 purporting to show that the risk of GSE default producing taxpayer loss was "effectively zero."[6]

One of the most successful efforts to influence lawmakers came through community groups. Both Fannie and Freddie made "charitable" or other gifts to community groups, which could then be called upon to contact the GSEs' opponents in Congress and protest any proposed restrictions on the activities or privileges of the GSEs. GSE supporters in Congress could also count on these groups to back them in their reelection efforts.

But these activities, as important as they were in managing the GSEs' political risks, paled when compared to the billions of dollars the GSEs made available for spending on projects in the congressional districts and states of their supporters. Many of these projects involved affordable housing. In 1994, Fannie Mae replaced its initial $10 billion program with a $1 trillion affordable housing initiative, and both Fannie and Freddie announced new $2 trillion initiatives in 2001.[7] It is not clear to what extent the investments made in support of these commitments were losers—the GSEs' profitability over many years could cover a multitude of sins—but it is now certain that the enormous losses associated with the risky housing investments appearing on Fannie and Freddie's balance sheet today reflect major and imprudent investments in support of affordable housing between 2005 and 2007—investments that ultimately brought about the collapse of Fannie and Freddie.

Even if the earlier affordable housing projects were not losers, however, they represented a new and extraconstitutional way for Congress to dispense funds that should otherwise have flowed through the appropriations process. In one sense, the expenditures were a new form of earmark, but this earmarking evaded the constitutional appropriations process entirely. An illustration is provided by a press release from the office of Senator Charles E. Schumer (D-N.Y.), one of the most ardent supporters of the GSEs in Congress. The headline on the release, dated November 20, 2006—right in the middle of the GSEs' affordable housing spending spree—was

Even if the earlier affordable housing projects were not losers, they represented a new and extraconstitutional way for Congress to dispense funds that should otherwise have flowed through the appropriations process.

"Schumer Announces up to $100 Million Freddie Mac Commitment to Address Fort Drum and Watertown Housing Crunch." The subheading continued: "Schumer Unveils New Freddie Mac Plan with HSBC That Includes Low-Interest Low-Downpayment Loans. In June, Schumer Urged Freddie Mac and Fannie Mae Step Up to the Plate and Deliver Concrete Plans—Today Freddie Mac Is Following Through."[8] If this project had been economically profitable for Fannie or Freddie, Schumer would not have had to "urge" them to "step up." Instead, using his authority as a powerful member of the Senate Banking Committee—and a supporter of Fannie and Freddie—he appears to have induced Freddie Mac to make a financial commitment that was very much in his political interests but for which the taxpayers of the United States would ultimately be responsible.

Of course, Schumer was only one of many members of Congress who used his political leverage to further his own agenda at taxpayer expense and outside the appropriations process. The list of friends of Fannie and Freddie changed over time; while the GSEs enjoyed broad bipartisan support in the 1990s, over the past decade, they have become increasingly aligned with the Democrats. This shift in the political equilibrium was especially clear in the congressional reaction to the GSEs' accounting scandals of 2003 and 2004.

The Accounting Scandals

Fannie and Freddie reaped significant benefits from the careful management of their political risk. In June 2003, in the wake of the failures of Enron and WorldCom, Freddie's board of directors suddenly dismissed its three top officers and announced that the company's accountants had found serious problems in Freddie's financial reports. In 2004, after a forensic audit by OFHEO, even more serious accounting manipulation was found at Fannie, and Raines, its chairman, and Timothy Howard, its chief financial officer, were compelled to resign.

It is eloquent testimony to the power of Fannie and Freddie in Congress that even after these extraordinary events there was no significant effort to improve or enhance the powers of their regulator. The House Financial Services Committee developed a bill that was so badly weakened by GSE lobbying that the Bush administration refused to support it. The Senate Banking Committee, then under Republican control, adopted much stronger legislation in 2005, but unanimous Democratic opposition to the bill in the committee doomed it when it reached the floor. Without any significant Democratic support, debate could not be ended in the Senate, and the bill was never brought up for a vote. This was a crucial missed opportunity. The bill prohibited the GSEs from holding portfolios of mortgages and mortgage-backed securities (MBS); that measure alone would have prevented the disastrous investment activities of the GSEs in the years that followed. GSE immunity to accounting scandal is especially remarkable when it is recalled that after accounting fraud was found at Enron (and later at WorldCom), Congress adopted the punitive Sarbanes-Oxley Act, which imposed substantial costs on every public company in the United States. The GSEs' investment in controlling their political risk—at least among the Democrats—was apparently money well spent.

> The failure to adopt meaningful GSE reform in 2005 was a crucial missed opportunity.

Nevertheless, the GSEs' problems were mounting quickly. The accounting scandal, although contained well below the level of the Enron story, gave ammunition to GSE critics inside and outside of Congress. Alan Greenspan, who in his earlier years as Federal Reserve chairman had avoided direct criticism of the GSEs, began to cite the risks associated with their activities in his congressional testimony. In a hearing before the Senate Banking Committee in February 2004, Greenspan noted for the first time that they could have serious adverse consequences for the economy. Referring to the management of interest rate risk—a key risk associated with holding portfolios of mortgages or MBS—he said:

> To manage this risk with little capital requires a conceptually sophisticated hedging framework. In essence, the current system depends on the risk managers at Fannie and Freddie to do everything just right, rather than depending on a market-based system supported by the risk assessments and management capabilities of many participants with different views and different strategies for hedging risks.[9]

Then, and again for the first time, Greenspan proposed placing some limit on the size of the GSEs' portfolios. Greenspan's initial idea, later followed by more explicit proposals for numerical limits, was to restrict the GSEs' issuance of debt. Although he did not call for an outright reduction in the size of the portfolios, limiting the issuance of debt amounts to the same thing. If the GSEs could not issue debt beyond a certain amount, they also could not accumulate portfolios. Greenspan noted:

> Most of the concerns associated with systemic risks flow from the size of the balance sheets that these GSEs maintain. One way Congress could constrain the size of these balance sheets is to alter the composition of Fannie and Freddie's mortgage financing by limiting the dollar amount of their debt relative to the dollar amount of mortgages securitized and held by other investors. . . . [T]his approach would continue to expand the depth and liquidity of mortgage markets through mortgage securitization but would remove most of the potential systemic risks associated with these GSEs.[10]

This statement must have caused considerable concern to Fannie and Freddie. Most of their profits came from issuing debt at low rates of interest and holding portfolios of mortgages and MBS with high yields. This was a highly lucrative arrangement; limiting their debt issuance would have had a significant adverse effect on their profitability.

In addition, in January 2005, only a few months after the adverse OFHEO report on Fannie's accounting manipulation, three Federal Reserve economists published a study that cast doubt on whether the GSEs' activities had any significant effect on mortgage interest rates and concluded further that holding portfolios—a far risker activity than issuing MBS—did not have any greater effect on interest rates than securitization: "We find that both portfolio purchases and MBS issuance have negligible effects on mortgage rate spreads and that purchases are not any more effective than securitization at reducing mortgage interest rate spreads."[11] Thus, the taxpayer risks cited by Greenspan could not be justified by citing lower mortgage rates, and, worse, there was a strong case for limiting the GSEs to securitization activities alone—a much less profitable activity than issuing MBS.

The events in 2003 and 2004 had undermined the legitimacy of the GSEs. They could no longer claim to be competently—or even honestly—managed. An important and respected figure, Alan Greenspan, was raising questions about whether they might be creating excessive risk for taxpayers and systemic risk for the economy as a whole. Greenspan had suggested that their most profitable activity—holding portfolios of mortgages and MBS—was the activity that created the greatest risk, and three Federal Reserve economists had concluded that the GSEs' activities did not actually reduce mortgage interest rates. It was easy to see at this point that their political risk was rising quickly. The case for continuing their privileged status had been severely weakened. The only element of their activities that had not come under criticism was their affordable housing mission, and it appears that the GSEs determined at this point to play that card as a way of shoring up their political support in Congress.

From the perspective of their 2008 collapse, this may seem to have been unwise, but in the context of the time, it was a shrewd decision. It provided the GSEs with the potential for continuing their growth and delivered enormous short-term profits. Those profits were transferred to stockholders in huge dividend payments over the past three years (Fannie and Freddie paid a combined $4.1 billion in dividends last year alone) and to managers in lucrative salaries and bonuses. Indeed, if it had not been for the Democrats' desire to adopt a housing relief bill before leaving for the 2008 August recess, no new regulatory regime for the GSEs would have been adopted at all. Only the Senate Republicans' position—that there would be no housing bill without GSE reform—overcame the opposition of Senators Christopher Dodd (D-Conn.), the banking committee chairman, and Schumer.

The GSEs' confidence in the affordable housing idea was bolstered by what appears to be a tacit understanding. Occasionally, this understanding found direct expression. For example, in his opening statement at a hearing in 2003, Representative Barney Frank (D-Mass.), now the chairman of the House Financial Services Committee, referred to an "arrangement" between Congress and the GSEs that tracks rather explicitly what actually happened: "Fannie and Freddie have played a very useful role in helping to make housing more affordable, both in general through leveraging the mortgage market, and in particular, they have a mission that this Congress has given them in return for some of the arrangements which are of some benefit to them to focus on affordable housing."[12] So here the arrangement is laid out: if the GSEs focus on affordable housing, their position is secure.

Increased Support for Affordable Housing

Affordable housing loans and subprime loans are not synonymous. Affordable housing loans can be traditional prime loans with adequate down payments, fixed rates, and an established and adequate borrower credit history. In trying to increase their commitment to affordable housing, however, the GSEs abandoned these standards. In 1995, HUD, the cabinet-level agency responsible for issuing regulations on the GSEs' affordable housing obligations, had ruled that the GSEs could get affordable housing credit for purchasing subprime loans. Unfortunately, the agency failed to require that these loans conform to good lending practices, and OFHEO did not have the staff or the authority to monitor their purchases. The assistant HUD secretary at the time, William Apgar, later told the *Washington Post* that "[i]t was a mistake. In hindsight, I would have done it differently." Allen Fishbein, his adviser, noted that Fannie and Freddie "chose not to put the brakes on this dangerous lending when they should have."[13] Far from it. In 1998, Fannie Mae announced a 97 percent loan-to-value mortgage, and, in 2001, it offered a program that involved mortgages with no down payment at all. As a result, in 2004, when Fannie and Freddie began to increase significantly their commitment to affordable housing loans, they found it easy to stimulate production in the private sector by letting it be known in the market that they would gladly accept loans that would otherwise be considered subprime.

Although Fannie and Freddie were building huge exposures to subprime mortgages from 2005 to 2007, they adopted accounting practices that made it difficult to detect the size of those exposures. Even an economist as seemingly sophisticated as Paul Krugman was misled. He wrote in his July 14, 2008, *New York Times* column that

Although Fannie and Freddie were building huge exposures to subprime mortgages, they adopted accounting practices that made it difficult to detect the size of those exposures.

> Fannie and Freddie had nothing to do with the explosion of high-risk lending. . . . In fact, Fannie and Freddie, after growing rapidly in the 1990s, largely faded from the scene during the height of the housing bubble. . . . Partly that's because regulators, responding to accounting scandals at the companies, placed temporary restraints on both Fannie and Freddie that curtailed their lending just as housing prices were really taking off. Also, they didn't do any subprime lending, because they can't . . . by law. . . . So whatever bad incentives the implicit federal guarantee creates have been offset by the fact that Fannie and Freddie were and are tightly regulated with regard to the risks they can take. You could say that the Fannie-Freddie experience shows that regulation works.[14]

Here Krugman demonstrates confusion about the law (which did not prohibit subprime lending by the GSEs), misunderstands the regulatory regime under which they operated (which did not have the capacity to control their risk-taking), and mismeasures their actual subprime exposures (which he wrongly states were zero). There is probably more to this than lazy reporting by Krugman; the GSE propaganda machine purposefully misled people into believing that it was keeping risk low and operating under an adequate prudential regulatory regime.

One of the sources of Krugman's confusion may have been Fannie and Freddie's strange accounting conventions relating to subprime loans. There are many definitions of a subprime loan, but the definition used by U.S. bank regulators is any loan to a borrower with damaged credit, including such objective criteria as a FICO credit score lower than 660.[15] In their public reports, the GSEs use their own definitions, which purposely and significantly understate their commitment to subprime loans—the mortgages with the most political freight. For example, they disclose the principal amount of loans with FICO scores of less than 620, leaving the reader to guess how many loans fall into the category of subprime because they have FICO scores of less than 660. In these reports, too, Alt-A loans—which include loans with little or no income or other documentation and other deficiencies—are differentiated from subprime loans, again reducing the size of the apparent GSE commitment to the subprime category. These distinctions, however, are not very important from the perspective of realized losses in the subprime and Alt-A categories; loss rates are quite similar for both, even though they are labeled differently. In its June 30, 2008, Investor Summary report, Fannie notes that credit losses on its Alt-A portfolio were 49.6 percent of all the credit losses on its $2.7 trillion single-family loan book of business.[16] Fannie's disclosures indicate that when all subprime loans (including Alt-A) are aggregated, at least 85 percent of its losses are related to its holdings of both subprime and Alt-A loans. They are all properly characterized as "junk loans."

Beginning in 2004, after the GSEs' accounting scandals, the junk loan share of all mortgages in the United States began to rise, going from 8 percent in 2003 to about 18 percent in 2004 and peaking at about 22 percent in the third quarter of 2006. It is likely that this huge increase in commitments to junk lending was largely the result of signals from Fannie and Freddie that they were ready to buy these loans in bulk. For example, in speeches to the Mortgage Bankers Association in 2004, both Raines and Richard Syron—the chairmen, respectively, of Fannie and Freddie—"made no bones about their interest in buying loans made to borrowers formerly considered the province of nonprime and other niche lenders."[17] Raines is quoted as saying, "We have to push products and opportunities to people who have lesser credit quality."

There are few data available publicly on the dollar amount of junk loans held by the GSEs in 2004, but according to their own reports, GSE purchases of these mortgages and MBS increased substantially between 2005 and 2007. Subprime and Alt-A purchases during this period were a higher share of total purchases than in previous years. For example, Fannie reported that mortgages and MBS of all types originated in 2005–2007 comprised 49.8 percent of its overall book of single-family mortgages, which includes both mortgages and MBS retained in their portfolio as well as mortgages they securitized and guaranteed. But the percentage of mortgages *with subprime characteristics* purchased during this period consistently exceeded 49.8 percent, demonstrating that Fannie was substantially increasing its reliance on junk loans between 2005 and 2007. For example, in its 10-Q Investor Summary report for the quarter ended June 30, 2008, Fannie reported that mortgages with subprime characteristics comprised substantial percentages of all 2005–2007 mortgages the company acquired, as shown in table 1. Based on these figures, it is likely that as much as 40 percent of the mortgages that Fannie Mae added to its single-family book of business during 2005–2007 were junk loans.

If we add up all these categories and eliminate double counting, it appears that on June 30, 2008, Fannie held or had guaranteed subprime and Alt-A loans with an unpaid principal balance of $553 billion. In addition, according to the same Fannie report, the company also held $29.5 billion of Alt-A loans and $36.3 billion of subprime loans that it had purchased as private label securities (non-GSE or Ginnie Mae securities).[18] These figures amount to a grand total of $619 billion—approximately 23 percent of Fannie's book of single-family business on June 30, 2008—and reflect a huge commitment to the purchase of mortgages of questionable quality between 2005 and 2007.

Freddie Mac also published a report on its subprime and Alt-A mortgage exposures as of August 2008. Freddie's numbers were not as detailed as Fannie's, but the company reported that 52 percent of its entire single-family credit guarantee portfolio was from book years 2005–2007 (slightly more than Fannie) and that these mortgages had subprime characteristics, as shown in table 2. Based on these figures, it appears that as much as 40 percent of the loans that Freddie Mac added to its book of single-family mortgage business during 2005–2007 also consisted of junk loans.

Freddie's disclosures did not contain enough detail to eliminate all of the double counting, so it is not possible to estimate the total amount of its subprime loans from the information it reported. Nevertheless, we can calculate the minimum amount of Freddie's exposure. In the same report, Freddie disclosed that $190 billion of its loans were categorized as Alt-A and $68 billion had FICO credit scores of less than 620, so that they would clearly be categorized as subprime. Based on the limited information Freddie supplied, double counting of $7.6 billion can be

TABLE 1
SUBPRIME CHARACTERISTICS OF MORTGAGES ACQUIRED BY FANNIE MAE, 2005–2007

Subprime Characteristic	Percentage
Negative amortization (option ARMs):	62.2
Interest-only:	83 8
FICO scores less than 620:	57.5
Loan-to-value ratios greater than 90:	62.0
Alt-A:	73 0

SOURCE Fannie Mae, "2008 Q2 10-Q Investor Summary," August 8, 2008, available at www fanniemae com/media/pdf/newsreleases/2008_Q2_10Q_Investor_Summary pdf (accessed September 29, 2008)

TABLE 2
SUBPRIME CHARACTERISTICS OF MORTGAGES ACQUIRED BY FREDDIE MAC, 2005–2007

Subprime Characteristic	Percentage
Negative amortization (option ARMs).	72
Interest-only:	90
FICO scores less than 620:	61
Loan-to-value ratios of greater than 90:	58
Alt-A:	78

SOURCE Freddie Mac, "Freddie Mac Update," August 2008, 30, available at www freddiemac com/investors/pdffiles/investor-presentation pdf (accessed September 29, 2008) eliminated, so that as of August 2008, Freddie held or had guaranteed at least $258 billion of junk loans. To this must be added $134 billion of subprime and Alt-A loans that Freddie purchased from private label issuers,[19] for a grand total of $392 billion—20 percent of Freddie's single-family portfolio of $1.8 trillion.

A New Trillion-Dollar Commitment

Between 2005 and 2007, Fannie and Freddie acquired so many junk mortgages that, as of August 2008, they held or had guaranteed more than $1.011 trillion in unpaid principal balance exposures on these loans. The losses already recognized on these exposures were responsible for the collapse of Fannie and Freddie and their takeover by the federal government, and there are undoubtedly many more losses to come. In congressional testimony on September 23, James Lockhart, the director of their new regulator, the Federal Housing Finance Agency, cited these loans as the source of the GSEs' ultimate collapse, as reported in the *Washington Post*:

> Fannie Mae and Freddie Mac purchased and guaranteed "many more low-documentation, low-verification and non-standard" mortgages in 2006 and 2007 "than they had in the past." He said the companies increased their exposure to risks in 2006 and 2007 despite the regulator's warnings.
>
> Roughly 33 percent of the companies' business involved buying or guaranteeing these risky mortgages, compared with 14 percent in 2005. Those bad debts on mortgages led to billions of dollars in losses at the firms. "The capacity to raise capital to absorb further losses without Treasury Department support vanished," Lockhart said.[20]

After the accounting scandals, the junk loan share of all mortgages in the United States began to rise, peaking at about 22 percent in 2006.

Although a large share of the subprime loans now causing a crisis in the international financial markets are so-called private label securities—issued by banks and securitizers other than Fannie Mae and Freddie Mac—the two GSEs became the biggest buyers of the AAA tranches of these subprime pools in 2005–07.[21] Without their commitment to purchase the AAA tranches of these securitizations, it is unlikely that the pools could have been formed and marketed around the world. Accordingly, not only did the GSEs destroy their own financial condition with their excessive purchases of subprime loans in the three-year period from 2005 to 2007, but they also played a major role in weakening or destroying the solvency and stability of other financial institutions and investors in the United States and abroad.

Why Did They Do It?

Why did the GSEs follow this disastrous course? One explanation—advanced by Lockhart—is that Fannie and Freddie were competing for market share with the private label securitizers and had to purchase substantial amounts of subprime mortgages in order to retain their position in a growing market. Fannie and Freddie's explanation is that they were the victims of excessively stringent HUD affordable housing goals. Neither of these explanations is plausible. For many years before 2004, Fannie and Freddie had followed relatively prudent investment strategies, even with respect to affordable housing, but they suddenly changed their approach in 2005. Freddie Mac's report, for example, shows that the percentage of mortgages in its portfolio with subprime characteristics rose rapidly after 2004. In addition, Freddie Mac's disclosures indicate that of the loans added to its portfolio of single-family loans between 2005 and 2007, 97 percent were interest-only mortgages, 85 percent were Alt-A, 72 percent were negative amortization loans, 67 percent had FICO scores lower than 620, and 68 percent had original loan-to-value ratios greater than 90 percent. It seems unlikely that competing for market share or complying with HUD regulations—which contained no enforcement mechanism other than disclosure and delay in approving requests for mission expansions—could be the reason for such an obviously destructive course.

Instead, it seems likely that the event responsible for the GSEs' change in direction and culture was the accounting scandal that each of them encountered in 2003 and 2004. In both cases, they lost their reputation as well-managed companies and began to encounter questions about their contribution to reducing mortgage rates and their safety and soundness. Serious observers questioned whether they should be allowed to continue to hold mortgages and MBS in their portfolios—by far their most profitable activity—and Senate Republicans moved a bill out of committee that would have prohibited this activity.

Under these circumstances, the need to manage their political risk became paramount, and this required them to prove to their supporters in Congress that they still served a useful purpose. In 2003, as noted above, Frank had cited an arrangement in which the GSEs' congressional benefits were linked to their investments in affordable housing. In this context, substantially increasing their support for affordable housing—through the purchase of the subprime loans permitted by HUD—seems a logical and even necessary tactic.

Unfortunately, the sad saga of Fannie and Freddie is not over. Some of their supporters in Congress prefer to blame the Fannie and Freddie mess on deregulation or private market failure, perhaps hoping to use such false diagnoses to lay the groundwork for reviving the GSEs for extra constitutional expenditure and political benefit in the future. As the future of the GSEs is debated over the coming months and years, it will be important to remember how and why Fannie and Freddie failed. The primary policy objective should be to prevent a repeat of this disaster by preventing the restoration of the GSE model.

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THE RECKONING

Pressured to Take More Risk, Fannie Reached Tipping Point

By CHARLES DUHIGG

"Almost no one expected what was coming. It's not fair to blame us for not predicting the unthinkable."— Daniel H. Mudd, former chief executive, Fannie Mae

When the mortgage giant Fannie Mae recruited Daniel H. Mudd, he told a friend he wanted to work for an altruistic business. Already a decorated marine and a successful executive, he wanted to be a role model to his four children — just as his father, the television journalist Roger Mudd, had been to him.

Fannie, a government-sponsored company, had long helped Americans get cheaper home loans by serving as a powerful middleman, buying mortgages from lenders and banks and then holding or reselling them to Wall Street investors. This allowed banks to make even more loans — expanding the pool of homeowners and permitting Fannie to ring up handsome profits along the way.

But by the time Mr. Mudd became Fannie's chief executive in 2004, his company was under siege. Competitors were snatching lucrative parts of its business. Congress was demanding that Mr. Mudd help steer more loans to low-income borrowers. Lenders were threatening to sell directly to Wall Street unless Fannie bought a bigger chunk of their riskiest loans.

So Mr. Mudd made a fateful choice. Disregarding warnings from his managers that lenders were making too many loans that would never be repaid, he steered Fannie into more treacherous corners of the mortgage market, according to executives.

For a time, that decision proved profitable. In the end, it nearly destroyed the company and threatened to drag down the housing market and the economy.

Dozens of interviews, most from people who requested anonymity to avoid legal repercussions, offer an inside account of the critical juncture when Fannie Mae's new chief executive, under pressure from Wall Street firms, Congress and company shareholders, took additional risks that pushed his company, and, in turn, a large part of the nation's financial health, to the brink.

Between 2005 and 2008, Fannie purchased or guaranteed at least $270 billion in loans to risky borrowers — more than three times as much as in all its earlier years combined, according to company filings and industry data.

"We didn't really know what we were buying," said Marc Gott, a former director in Fannie's loan servicing department. "This system was designed for plain vanilla loans, and we were trying to push chocolate sundaes through the gears."

Last month, the White House was forced to orchestrate a $200 billion rescue of Fannie and its corporate cousin, Freddie Mac. On Sept. 26, the companies disclosed that federal prosecutors and the Securities and Exchange Commission were investigating potential accounting and governance problems.

Mr. Mudd said in an interview that he responded as best he could given the company's challenges, and worked to balance risks prudently.

"Fannie Mae faced the danger that the market would pass us by," he said. "We were afraid that lenders would be selling products we weren't buying and Congress would feel like we weren't fulfilling our mission. The market was changing, and it's our job to buy loans, so we had to change as well."

Dealing With Risk

When Mr. Mudd arrived at Fannie eight years ago, it was beginning a dramatic expansion that, at its peak, had it buying 40 percent of all domestic mortgages.

Just two decades earlier, Fannie had been on the brink of bankruptcy. But chief executives like Franklin D. Raines and the chief financial officer J. Timothy Howard built it into a financial juggernaut by aiming at new markets.

Fannie never actually made loans. It was essentially a mortgage insurance company, buying mortgages, keeping some but reselling most to investors and, for a fee, promising to pay off a loan if the borrower defaulted. The only real danger was that the company might guarantee questionable mortgages and lose out when large numbers of borrowers walked away from their obligations.

So Fannie constructed a vast network of computer programs and mathematical formulas that analyzed its millions of daily transactions and ranked borrowers according to their risk.

Those computer programs seemingly turned Fannie into a divining rod, capable of separating pools of similar-seeming borrowers into safe and risky bets. The riskier the loan, the more Fannie charged to handle it. In theory, those high fees would offset any losses.

With that self-assurance, the company announced in 2000 that it would buy $2 trillion in loans from low-income, minority and risky borrowers by 2010.

All this helped supercharge Fannie's stock price and rewarded top executives with tens of millions of dollars. Mr. Raines received about $90 million between 1998 and 2004, while Mr. Howard was paid about $30.8 million, according to regulators. Mr. Mudd collected more than $10 million in his first four years at Fannie.

Whenever competitors asked Congress to rein in the company, lawmakers were besieged with letters and phone calls from angry constituents, some orchestrated by Fannie itself. One automated phone call warned voters: "Your congressman is trying to make mortgages more expensive. Ask him why he opposes the American dream of home ownership."

The ripple effect of Fannie's plunge into riskier lending was profound. Fannie's stamp of approval made shunned borrowers and complex loans more acceptable to other lenders, particularly small and less sophisticated banks.

Between 2001 and 2004, the overall subprime mortgage market — loans to the riskiest borrowers — grew from $160 billion to $540 billion, according to Inside Mortgage Finance, a trade publication. Communities were inundated with billboards and fliers from subprime companies offering to help almost anyone buy a home.

Within a few years of Mr. Mudd's arrival, Fannie was the most powerful mortgage company on earth.

Then it began to crumble.

Regulators, spurred by the revelation of a wide-ranging accounting fraud at Freddie, began scrutinizing Fannie's books. In 2004 they accused Fannie of fraudulently concealing expenses to make its profits look bigger.

Mr. Howard and Mr. Raines resigned. Mr. Mudd was quickly promoted to the top spot.

But the company he inherited was becoming a shadow of its former self.

'You Need Us'

Shortly after he became chief executive, Mr. Mudd traveled to the California offices of Angelo R. Mozilo, the head of Countrywide Financial, then the nation's largest mortgage lender. Fannie had a longstanding and lucrative relationship with Countrywide, which sold more loans to Fannie than anyone else.

But at that meeting, Mr. Mozilo, a butcher's son who had almost single-handedly built Countrywide into a financial powerhouse, threatened to upend their partnership unless Fannie started buying Countrywide's riskier loans.

Mr. Mozilo, who did not return telephone calls seeking comment, told Mr. Mudd that Countrywide had other options. For example, Wall Street had recently jumped into the market for risky mortgages. Firms like Bear Stearns, Lehman Brothers and Goldman Sachs had started bundling home loans and selling them to investors — bypassing Fannie and dealing with Countrywide directly.

"You're becoming irrelevant," Mr. Mozilo told Mr. Mudd, according to two people with knowledge of the meeting who requested anonymity because the talks were confidential. In the previous year, Fannie had already lost 56 percent of its loan-reselling business to Wall Street and other competitors.

"You need us more than we need you," Mr. Mozilo said, "and if you don't take these loans, you'll find you can lose much more."

Then Mr. Mozilo offered everyone a breath mint.

Investors were also pressuring Mr. Mudd to take greater risks.

On one occasion, a hedge fund manager telephoned a senior Fannie executive to complain that the company was not taking enough gambles in chasing profits.

"Are you stupid or blind?" the investor roared, according to someone who heard the call, but requested anonymity. "Your job is to make me money!"

Capitol Hill bore down on Mr. Mudd as well. The same year he took the top position, regulators sharply increased Fannie's affordable-housing goals. Democratic lawmakers demanded that the company buy more loans that had been made to low-income and minority homebuyers.

"When homes are doubling in price in every six years and incomes are increasing by a mere one percent per year, Fannie's mission is of paramount importance," Senator Jack Reed, a Rhode Island Democrat, lectured Mr. Mudd at a Congressional hearing in 2006. "In fact, Fannie and Freddie can do more, a lot more."

But Fannie's computer systems could not fully analyze many of the risky loans that customers, investors and lawmakers wanted Mr. Mudd to buy. Many of them — like balloon-rate mortgages or mortgages that did not require paperwork — were so new that dangerous bets could not be identified, according to company executives.

Even so, Fannie began buying huge numbers of riskier loans.

In one meeting, according to two people present, Mr. Mudd told employees to "get aggressive on risk-taking, or get out of the company."

In the interview, Mr. Mudd said he did not recall that conversation and that he always stressed taking only prudent risks.

Employees, however, say they got a different message.

"Everybody understood that we were now buying loans that we would have previously rejected, and that the models were telling us that we were charging way too little," said a former senior Fannie executive. "But our mandate was to stay relevant and to serve low-income borrowers. So that's what we did."

Between 2005 and 2007, the company's acquisitions of mortgages with down payments of less than 10 percent almost tripled. As the market for risky loans soared to $1 trillion, Fannie expanded in white-hot real estate areas like California and Florida.

For two years, Mr. Mudd operated without a permanent chief risk officer to guard against unhealthy hazards. When Enrico Dallavecchia was hired for that position in 2006, he told Mr. Mudd that the company should be charging more to handle risky loans.

In the following months to come, Mr. Dallavecchia warned that some markets were becoming overheated and argued that a housing bubble had formed, according to a person with knowledge of the conversations. But many of the warnings were rebuffed.

Mr. Mudd told Mr. Dallavecchia that the market, shareholders and Congress all thought the companies should be taking more risks, not fewer, according to a person who observed the conversation. "Who am I supposed to fight with first?" Mr. Mudd asked.

In the interview, Mr. Mudd said he never made those comments. Mr. Dallavecchia was among those whom Mr. Mudd forced out of the company during a reorganization in August.

Mr. Mudd added that it was almost impossible during most of his tenure to see trouble on the horizon, because Fannie interacts with lenders rather than borrowers, which creates a delay in recognizing market conditions.

He said Fannie sought to balance market demands prudently against internal standards, that executives always sought to avoid unwise risks, and that Fannie bought far fewer troublesome loans than many other financial institutions. Mr. Mudd said he heeded many warnings from his executives and that Fannie refused to buy many risky loans, regardless of outside pressures .

"You're dealing with massive amounts of information that flow in over months," he said. "You almost never have an 'Oh, my God' moment. Even now, most of the loans we bought are doing fine."

But, of course, that moment of truth did arrive. In the middle of last year it became clear that millions of borrowers would stop paying their mortgages. For Fannie, this raised the terrifying prospect of paying billions of dollars to honor its guarantees.

Sustained by Government

Had Fannie been a private entity, its comeuppance might have happened a year ago. But the White House, Wall Street and Capitol Hill were more concerned about the trillions of dollars in other loans that were poisoning financial institutions and banks.

Lawmakers, particularly Democrats, leaned on Fannie and Freddie to buy and hold those troubled debts, hoping that removing them from the system would help the economy recover. The companies, eager to regain market share and buy what they thought were undervalued loans, rushed to comply.

The White House also pitched in. James B. Lockhart, the chief regulator of Fannie and Freddie, adjusted the companies' lending standards so they could purchase as much as $40 billion in new subprime loans. Some in Congress praised the move.

"I'm not worried about Fannie and Freddie's health, I'm worried that they won't do enough to help out the economy," the chairman of the House Financial Services Committee, Barney Frank, Democrat of Massachusetts, said at the time. "That's why I've supported them all these years — so that they can help at a time like this."

But earlier this year, Treasury Secretary Henry M. Paulson Jr. grew concerned about Fannie's and Freddie's stability. He sent a deputy, Robert K. Steel, a former colleague from his time at Goldman Sachs, to speak with Mr. Mudd and his counterpart at Freddie.

Mr. Steel's orders, according to several people, were to get commitments from the companies to raise more money as a cushion against all the new loans. But when he met with the firms, Mr. Steel made few demands and seemed unfamiliar with Fannie's and Freddie's operations, according to someone who attended the discussions.

Rather than getting firm commitments, Mr. Steel struck handshake deals without deadlines.

That misstep would become obvious over the coming months. Although Fannie raised $7.4 billion, Freddie never raised any additional money.

Mr. Steel, who left the Treasury Department over the summer to head Wachovia bank, disputed that he had failed in his handling of the companies, and said he was proud of his work .

As the housing crisis worsened, Fannie and Freddie announced larger losses, and shares continued falling.

In July, Mr. Paulson asked Congress for authority to take over Fannie and Freddie, though he said he hoped never to use it. "If you've got a bazooka and people know you've got it, you may not have to take it out," he told Congress.

Mr. Mudd called Treasury weekly. He offered to resign, to replace his board, to sell stock, and to raise debt. "We'll sign in blood anything you want," he told a Treasury official, according to someone with knowledge of the conversations.

But, according to that person, Mr. Mudd told Treasury that those options would work only if government officials publicly clarified whether they intended to take over Fannie. Otherwise, potential investors would refuse to buy the stock for fear of being wiped out.

"There were other options on the table short of a takeover," Mr. Mudd said. But as long as Treasury refused to disclose its goals, it was impossible for the company to act, according to people close to Fannie.

Then, last month, Mr. Mudd was instructed to report to Mr. Lockhart's office. Mr. Paulson told Mr. Mudd that he could either agree to a takeover or have one forced upon him.

"This is the right thing to do for the economy," Mr. Paulson said, according to two people with knowledge of the talks. "We can't take any more risks."

Freddie was given the same message. Less than 48 hours later, Mr. Lockhart and Mr. Paulson ended Fannie and Freddie's independence, with up to $200 billion in taxpayer money to replenish the companies' coffers.

The move failed to stanch a spreading panic in the financial world. In fact, some analysts say, the takeover accelerated the hysteria by signaling that no company, no matter how large, was strong enough to withstand the losses stemming from troubled loans.

Within weeks, Lehman Brothers was forced to declare bankruptcy, Merrill Lynch was pushed into the arms of Bank of America, and the government stepped in to bail out the insurance giant the American International Group.

Today, Mr. Paulson is scrambling to carry out a $700 billion plan to bail out the financial sector, while Mr.

Lockhart effectively runs Fannie and Freddie.

Mr. Raines and Mr. Howard, who kept most of their millions, are living well. Mr. Raines has improved his golf game. Mr. Howard divides his time between large homes outside Washington and Cancun, Mexico, where his staff is learning how to cook American meals.

But Mr. Mudd, who lost millions of dollars as the company's stock declined and had his severance revoked after the company was seized, often travels to New York for job interviews. He recalled that one of his sons recently asked him why he had been fired.

"Sometimes things don't work out, no matter how hard you try," he replied.

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Obama Voted 'Present' on Mortgage Reform

The only banking 'deregulation' in recent years was that of Fan and Fred.

By PETER J. WALLISON

In each of the first two presidential debates, Barack Obama claimed that "Republican deregulation" is responsible for the financial crisis. Most viewers probably accepted this idea, especially because Republicans generally *do* favor deregulation.

But one essential fact was missing from the senator's narrative: While there has been significant deregulation in the U.S. economy during the last 30 years, none of it has occurred in the financial sector. Indeed, the only significant legislation with any effect on financial risk-taking was the Federal Deposit Insurance Corporation Improvement Act of 1991, adopted during the first Bush administration in the wake of the collapse of the savings and loans (S&Ls). FDICIA, however, substantially *tightened* commercial bank and S&L regulations, including prompt corrective action when a bank's capital declines below adequate levels and severe personal fines if management violates laws or regulations.

If Sen. Obama had been asked for an example of "Republican deregulation," he would probably have cited the Gramm-Leach-Bliley Act of 1999 (GLBA), which has become a popular target for Democrats searching for something to pin on the GOP. This is puzzling. The bill's key sponsors were indeed Republicans, but the bill was supported by the Clinton administration and signed by President Clinton. The GLBA's "repeal" of a portion of the Glass-Steagall Act of 1933 is said to have somehow contributed to the current financial meltdown. Nonsense.

Adopted early in the New Deal, the Glass-Steagall Act separated investment and commercial banking. It prohibited commercial banks from underwriting or dealing in securities, and from affiliating with firms that engaged principally in that business. The GLBA repealed only the second of these provisions, allowing banks and securities firms to be affiliated under the same holding company. Thus J.P. Morgan Chase was able to acquire Bear Stearns, and Bank of America could acquire Merrill Lynch. Nevertheless, banks themselves were and still are prohibited from underwriting or dealing in securities.

Allowing banks and securities firms to affiliate under the same holding company has had no effect on the current financial crisis. None of the investment banks that have gotten into trouble -- Bear, Lehman, Merrill, Goldman or Morgan Stanley -- were affiliated with commercial banks. And none of the banks that have major securities affiliates -- Citibank, Bank of America, and J.P. Morgan Chase, to name a few -- are among the banks that have thus far encountered serious financial problems. Indeed, the ability of these banks to diversify into nonbanking activities has been a source of their strength.

Most important, the banks that have succumbed to financial problems -- Wachovia, Washington Mutual and IndyMac, among others -- got into trouble by investing in bad mortgages or mortgage-backed securities, not because of the securities activities of an affiliated securities firm. Federal Reserve regulations significantly restrict transactions between banks and their affiliates.

If Sen. Obama were truly looking for a kind of deregulation that might be responsible for the current financial crisis, he need only look back to 1998, when the Clinton administration ruled that Fannie Mae and Freddie Mac could satisfy their affordable housing obligations by purchasing subprime mortgages. This ultimately made it possible for Fannie and Freddie to add a trillion dollars in junk loans to their balance sheets. This led to their own collapse, and to the development of a market in these mortgages that is the source of the financial crisis we are wrestling with today.

Finally, on the matter of deregulation and the financial crisis, Sen. Obama should consider his own complicity in the failure of Congress to adopt legislation that might have prevented the subprime meltdown.

In the summer of 2005, a bill emerged from the Senate Banking Committee that considerably tightened regulations on Fannie and Freddie, including controls over their capital and their ability to hold portfolios of mortgages or mortgage-backed securities. All the Republicans voted for the bill in committee; all the Democrats voted against it. To get the bill to a vote in the Senate, a few Democratic votes were necessary to limit debate. This was a time for the leadership Sen. Obama says he can offer, but neither he nor any other Democrat stepped forward.

Instead, by his own account, Mr. Obama wrote a letter to the Treasury Secretary, allegedly putting himself on record that subprime loans were dangerous and had to be dealt with. This is revealing; if true, it indicates Sen. Obama knew there was a problem with subprime lending -- but was unwilling to confront his own party by pressing for legislation to control it. As a demonstration of character and leadership capacity, it bears a strong resemblance to something else in Sen. Obama's past: voting present.

Mr. Wallison is a senior fellow at the American Enterprise Institute.

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PHILLIP MORRIS

Time to account for foreclosures

Now we're getting somewhere. The rogues and the cockroaches are being fingered.

Mortgage broker Mark Kellogg was showcased last week as the sinister face of foreclosure in Cleveland. He was indicted on multiple counts that included fraud, forgery and money laundering.

But Kellogg stands far from being the genius behind the plague that turned parts of Cleveland into Soweto. He's not even at the financial heart of the foreclosure epidemic. The real profiteers are the bankers who orchestrated the lending schemes.

They should remain enemy No. 1.

Kellogg is a useful start, though. Prosecutors and other informed observers say he and a couple of cohorts engaged in a pattern of financial corruption that turned swaths of Cleveland's Slavic Village into wasteland.

Investigators say he and a couple of slick paper handlers preyed on a collection of unwary dopes and dunces who coveted homeownership. Kellogg peddled the American dream as something that could be had for nothing. There were no shortages of takers.

Kellogg, a Cleveland Heights broker, could put you into a house — or better yet, sell you a block of homes — for no money down. He could turn you into a real estate mogul on somebody else's dime.

No credit. No problem.

Prosecutors say Kellogg could invent you some.

No work history. No problem.

Investigators say Kellogg could create that, too.

He could make something out of nothing. That's what he did for Ervin Johnson.

I met Johnson last summer. He and Kellogg had fallen out, and the FBI was sniffing around Johnson and his wife. Investigators were asking questions about how the couple had amassed nearly $2 million in residential property between 2005 and 2006.

Johnson, a grass cutter, had never made more than $10,000 in a year. His wife was a nurse's aide. They lived in subsidized housing.

But like a magician, Kellogg changed their lives with a stroke of a pen, making Johnson into a landscaper who made $60,000 in 2005. And then he found the couple a friendly out-of-state bank.

Without a dime down, the Johnsons bought more than a dozen crumbling Cleveland houses, which made them millionaires on paper. In reality, their dilapidated houses weren't worth scrap.

I asked Kellogg last summer how he justified putting unfit borrowers into predatory mortgages that accelerated Cleveland's foreclosure cancer.

He told me he was playing by the rules.

He also denied molding Johnson a fictitious work history. He said he merely cleaned him up.

"I didn't create a work history for him. I merely helped him document what he said he had done, for the purposes of the loan," Kellogg said then.

That's how loose the housing game was being played — from broke borrowers to unscrupulous lenders to Wall Street.

Kellogg is probably on his way to prison. It's probably where he belongs. But he was only an opportunist. He didn't get rich off recycled blight. But many did.

The bankers who financed, and once greatly profited from Cleveland's foreclosure epidemic, remain in the shadows.

It's time they hang, too.

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THE RECKONING

Building Flawed American Dreams

By DAVID STREITFELD and GRETCHEN MORGENSON

SAN ANTONIO — A grandson of Mexican immigrants and a former mayor of this town, Henry G. Cisneros has spent years trying to make the dream of homeownership come true for low-income families.

As the Clinton administration's top housing official in the mid-1990s, Mr. Cisneros loosened mortgage restrictions so first-time buyers could qualify for loans they could never get before.

Then, capitalizing on a housing expansion he helped unleash, he joined the boards of a major builder, KB Home, and the largest mortgage lender in the nation, Countrywide Financial — two companies that rode the housing boom, drawing criticism along the way for abusive business practices.

And Mr. Cisneros became a developer himself. The Lago Vista development here in his hometown once stood as a testament to his life's work.

Joining with KB, he built 428 homes for low-income buyers in what was a neglected, industrial neighborhood. He often made the trip from downtown to ask residents if they were happy.

"People bought here because of Cisneros," says Celia Morales, a Lago Vista resident. "There was a feeling of, 'He's got our back.' "

But Mr. Cisneros rarely comes around anymore. Lago Vista, like many communities born in the housing boom, is now under stress. Scores of homes have been foreclosed, including one in five over the last six years on the community's longest street, Sunbend Falls, according to property records.

While Mr. Cisneros says he remains proud of his work, he has misgivings over what his passion has wrought. He insists that the worst problems developed only after "bad actors" hijacked his good intentions but acknowledges that "people came to homeownership who should not have been homeowners."

They were lured by "unscrupulous participants — bankers, brokers, secondary market people," he says. "The country is paying for that, and families are hurt because we as a society did not draw a line."

The causes of the housing implosion are many: lax regulation, financial innovation gone awry, excessive debt, raw greed. The players are also varied: bankers, borrowers, developers, politicians and bureaucrats.

Mr. Cisneros, 61, had a foot in a number of those worlds. Despite his qualms, he encouraged the unprepared to buy homes — part of a broad national trend with dire economic consequences.

He reflects often on his role in the debacle, he says, which has changed homeownership from something that secured a place in the middle class to something that is ejecting people from it. "I've been waiting for someone to put all the blame at my doorstep," he says lightly, but with a bit of worry, too.

The Paydays During the Boom

After a sex scandal destroyed his promising political career and he left Washington, he eventually reinvented himself as a well-regarded advocate and builder of urban, working-class homes. He has financed the construction of more than 7,000 houses.

For the three years he was a director at KB Home, Mr. Cisneros received at least $70,000 in pay and more than $100,000 worth of stock. He also received $1.14 million in directors' fees and stock grants during the six years he was a director at Countrywide. He made more than $5 million from Countrywide stock options, money he says he plowed into his company.

He says his development work provides an annual income of "several hundred thousand" dollars. All told, his paydays are modest relative to the windfalls some executives netted in the boom. Indeed, Mr. Cisneros says his mistake was not the greed that afflicted many of his counterparts in banking and housing; it was unwavering belief.

It was, he argues, impossible to know in the beginning that the federal push to increase homeownership would end so badly. Once the housing boom got going, he suggests, laws and regulations barely had a chance.

"You think you have a finely tuned instrument that you can use to say: 'Stop! We're at 69 percent homeownership. We should not go further. There are people who should remain renters,' " he says. "But you really are just given a sledgehammer and an ax. They are blunt tools."

From people dizzily drawing home equity loans out of increasingly valuable houses to banks racking up huge fees, few wanted the party to end.

"I'm not sure you can regulate when we're talking about an entire nation of 300 million people and this behavior becomes viral," Mr. Cisneros says.

Homeownership has deep roots in the American soul. But until recently getting a mortgage was a challenge for low-income families. Many of these families were minorities, which naturally made the subject of special interest to Mr. Cisneros, who, in 1993, became the first Hispanic head of the Department of Housing and Urban Development.

He had President Clinton's ear, an easy charisma and a determination to increase a homeownership rate that had been stagnant for nearly three decades.

Thus was born the National Homeownership Strategy, which promoted ownership as patriotic and an easy win for all. "We were trying to be creative," Mr. Cisneros recalls.

Under Mr. Cisneros, there were small and big changes at HUD, an agency that greased the mortgage wheel for first-time buyers by insuring billions of dollars in loans. Families no longer had to prove they had five years of stable income; three years sufficed.

And in another change championed by the mortgage industry, lenders were allowed to hire their own appraisers rather than rely on a government-selected panel. This saved borrowers money but opened the door for inflated appraisals. (A later HUD inquiry uncovered appraisal fraud that imperiled the federal mortgage insurance fund.)

"Henry did everything he could for home builders while he was at HUD," says Janet Ahmad, president of Homeowners for Better Building, an advocacy group in San Antonio, who has known Mr. Cisneros since he was a city councilor. "That laid the groundwork for where we are now."

Mr. Cisneros, who says he has no recollection that appraisal rules were relaxed when he ran HUD, disputes that notion. "I look back at HUD and feel my hands were clean," he says.

Lenders applauded two more changes HUD made on Mr. Cisneros's watch: they no longer had to interview most government-insured borrowers face to face or maintain physical branch offices. The industry changed, too. Lenders sprang up to serve those whose poor credit history made them ineligible for lower-interest "prime" loans. Countrywide, which Angelo R. Mozilo co-founded in 1969, set up a subprime unit in 1996.

Mr. Cisneros met Mr. Mozilo while he was HUD secretary, when Countrywide signed a government pledge to use "proactive creative efforts" to extend homeownership to minorities and low-income Americans.

He met Bruce E. Karatz, the chief executive of KB Home, when both were helping Los Angeles rebuild after the Northridge earthquake in 1994.

There were real gains during the Clinton years, as homeownership rose to 67.4 percent in 2000 from 64 percent in 1994. Hispanics and African-Americans were the biggest beneficiaries. But as the boom later gathered steam, and as the Bush administration continued the Clinton administration's push to amplify homeownership, some of those gains turned out to be built on sand.

Mr. Cisneros left government in 1997 after revelations that he had lied to federal investigators about payments to a former mistress. In the following years, HUD continued to draw attention in the news media and among consumer advocates for an overly lenient posture toward the housing industry.

In 2000, Mr. Cisneros returned to San Antonio, where he formed American CityVista, a developer, in partnership with KB, and became a KB director. KB's board also included James A. Johnson, a prominent Democrat and the former chief executive of Fannie Mae, the mortgage giant now being run by the government. Mr. Johnson did not return a phone call seeking comment.

It made for a cozy network. Fannie bought or backed many mortgages received by home buyers in the KB Home/American CityVista partnership. And Fannie's biggest mortgage client was Countrywide, whose board Mr. Cisneros had joined in 2001.

Because American CityVista was privately held, Mr. Cisneros's earnings are not disclosed. He held a 65 percent stake, and KB had the rest. In 2002, KB paid $1.24 million to American CityVista for "services rendered."

'A Little Too Ambitious'

One of American CityVista's first projects, unveiled in late 2000, was Lago Vista — Spanish for "Lake View." The location was unusual: San Antonio's proud and insular South Side, a

Hispanic area home to secondhand car dealers, light industry and pawnshops.

Mr. Cisneros and KB pledged to transform an overgrown patch of land into a showcase. Homes were initially priced from $70,000 to about $95,000, and Mr. Cisneros promised that Lago Vista would be ringed with jogging paths and maple trees.

The paths were never built, and few trees provide shade from the Texas sun. The adjoining "lake" — at one point a run-off pit for an asphalt plant — is fenced off, a hazard to neighborhood children. The houses are gaily painted in pink, blue, yellow or tan, and most owners keep their yards green and tidy.

KB considers Lago Vista a "model community," a spokeswoman said.

To get things rolling in Lago Vista, traditional bars to homeownership were lowered to the ground. Fannie Mae, CityVista and KB promoted a program allowing police officers, firefighters, teachers and others to get loans with nothing down and no closing costs.

KB marketed its developments in videos. In one from 2003, Mr. Karatz declared: "One of the greatest misconceptions today is people who sit back and think, 'I can't afford to buy.' " Mr. Cisneros appeared — identified as a former HUD director — saying the time was ripe to buy a home. Many agreed.

Victor Ramirez and Lorraine Pulido-Ramirez bought a house in Lago Vista in 2002. "This was our first home. I had nothing to compare it to," Mr. Ramirez says. "I was a student making $17,000 a year, my wife was between jobs. In retrospect, how in hell did we qualify?"

The majority of buyers in Lago Vista "were duped into believing it was easier than it was," Mr. Ramirez says. "The attitude was, 'Sign here, sign here, don't read the fine print.' " He added that some fault lay with buyers: "We were definitely willing victims." (The Ramirez family veered close to foreclosure, but the couple now have good jobs and can make their payments.)

KB and Mr. Cisneros eventually built more than a dozen developments, primarily in Texas. But the shine slowly came off Lago Vista.

"It started off fabulously," Mr. Karatz recalled. Then sales slowed considerably. "It was probably, looking back, a little too ambitious to think that there would be sufficient local demand."

And then the foreclosures started. "A lot of people got approved for big amounts," says Patricia Flores, another Lago Vista homeowner. "They bit off more than they could chew." Families split up under the strain of mortgage payments. One residence had so much marital turmoil that neighbors nicknamed it "The House of Broken Love."

Some homes were taken over and sold at a loss by HUD, which had insured them. KB was also a mortgage lender, a business many home builders pursued because it was so profitable. At times, it was also problematic.

Officials at HUD uncovered problems with KB's lending. In 2005, about two years after Mr. Cisneros left the KB board, the agency filed an administrative action against KB for approving loans based on overstated or improperly documented borrower income, and for charging excessive fees. Because HUD does not specify where improprieties take place, it is not clear if this occurred at Lago Vista.

KB Home paid $3.2 million to settle the HUD action without admitting liability or fault, one of the largest settlements collected by the agency's mortgagee review board. Shortly afterward, KB sold its lending unit to Countrywide. Then they set up a joint venture: KB installed Countrywide sales representatives in its developments.

By 2007, almost three-quarters of the loans to KB buyers were made by the joint venture. In Lago Vista, residents secured loans from a spectrum of federal agencies and lenders.

During years of heady growth, and then during a deep financial slide, Countrywide became a lightning rod for criticism about excesses and abuses leading to the housing bust — which Countrywide routinely brushed off.

Mr. Cisneros says he was never aware of improprieties at KB or Countrywide, and worked with them because he was impressed by Mr. Karatz and Mr. Mozilo. Mr. Mozilo could not be reached for comment.

Still, Countrywide expanded subprime lending aggressively while Mr. Cisneros served on its board. In September 2004, according to documents provided by a former employee, lending audits in six of Countrywide's largest regions showed about one in eight loans was "severely unsatisfactory" because of shoddy underwriting.

HUD required such audits and lenders were expected to address problems. Mr. Cisneros was a member of the Countrywide committee that oversaw compliance with legal and regulatory requirements. But he says he did not recall seeing or receiving the reports.

Nor, he says, was there ever a board vote about the wisdom of subprime lending.

"The irresistible temptation to engage in subprime was Countrywide's fatal error," he says. "I fault myself for not having seen it and, since it was not something I could change, having left."

Mr. Cisneros left Countrywide's board last year. At the time, he expressed "enormous confidence in the leadership." In 2003, Mr. Cisneros ended his partnership with KB because, he says, he felt constrained working with just one builder. He formed a new company with the same mission, CityView, that has raised $725 million.

Mr. Karatz has a different recollection of why the partnership ended.

"It didn't become an important part of KB's business," he says. "It was profitable but I don't think as profitable in those initial years as Henry's group wanted it to be."

Troubles in Lago Vista

Today in Lago Vista, many are just trying to get by. Residents say crime has risen, and with association dues unpaid, they cannot hire security. Salvador Gutierrez, a truck driver, woke up recently to see four men stealing the tires off his pickup. Seventeen houses are for sale, but there are few buyers.

Hugo Martinez, who got a pair of Countrywide loans to buy a two-bedroom house with no down payment, recently lost his job with a car dealership. He has a lower-paying job as a mechanic and can't refinance or sell his house.

"They make it easy when you buy," Mr. Martinez says. "But after a while, the interest rate goes up. KB Home says they cannot help us at all."

Five years ago, Carlo Lee and Patricia Reyes bought their first home, a three-bedroom house in Lago Vista.

After Mrs. Reyes became ill last year and lost her job, they fell behind on their payments. Last month, Mr. Reyes was laid off from one of his jobs, assembling cabinets. He still works part time at a hospital, but unless the couple come up with missed payments and fees, they will lose their home.

"Everyone isn't happy here in Lago Vista," Mr. Reyes says. "Everyone has a lot of problems."

Countrywide was bought recently at a fire-sale price by Bank of America. Mr. Cisneros describes Mr. Mozilo as "sick with stress — the final chapter of his life is the infamy that's been brought on him, or that he brought on himself."

Mr. Karatz was forced out of KB two years ago amid a compensation scandal. Last month, without admitting or denying the allegations, he settled government charges that he illegally backdated stock options worth $6 million.

For his part, Mr. Cisneros says he is proud of Lago Vista. "It is inaccurate to say that we put people into homes that they couldn't afford," he says. "No one was forcing people into homes."

He also remains bullish on home building, despite the current carnage.

"We're not selling cigarettes," he says. "We're not drawing people into casino gambling. We're building the homes they're going to raise their families in."

David Streitfeld reported from San Antonio, and Gretchen Morgenson from New York.

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Saddest Thing About This Mess: Congress Had Chance To Stop It

By TERRY JONES
INVESTOR'S BUSINESS DAILY | Posted Friday, September 26, 2008 4:30 PM PT

Could the crisis at Fannie Mae-Freddie Mac and the subprime meltdown have been avoided? The answer is yes.

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As early as 1992, alarm bells were going off on the threat Fannie and Freddie posed to our financial system and our economy. Intervention at any point could have staved off today's crisis. But Democrats in Congress stood in the way.

As the president recently said, Democrats have been "resisting any efforts by Republicans in the Congress or by me . . . to put some standards and tighten up a little on Fannie Mae and Freddie Mac."

No, it wasn't President Bush who said that; it was President Clinton, Democrat, speaking just last week.

Interesting, because it was his administration's relentless focus on multiculturalism that led to looser lending standards and regulatory pressure on banks to make mortgage loans to shaky borrowers.

Freddie and Fannie, backed by an "implicit" taxpayer guarantee, bought hundreds of billions of dollars of those subprime loans.

The mortgage giants, whose executive suites were top-heavy with former Democratic officials (and some Republicans), worked with Wall Street to repackage the bad loans and sell them to investors.

As the housing market continued to fall in 2007, subprime loan portfolios suffered major losses. The crisis was on — though it was 15 years in the making.

Democrats Blocked Reform

Just as Republicans got blamed for Enron, WorldCom and other early-2000s scandals that were actually due to the anything-goes Clinton era, the media are now blaming them for the mortgage meltdown.

But Republicans tried repeatedly to bring fiscal sanity to Fannie and Freddie. Democrats opposed them, especially Sen. Chris Dodd and Rep. Barney Frank, who now run Congress' key banking panels.

History is utterly clear on this.

After Treasury Secretary Lawrence Summers warned Congress in 1999 of the "systemic risk" posed by Fannie and Freddie, Congress held hearings the next year.

But nothing was done. Why? Fannie and Freddie had donated millions to key congressmen and radical groups, ensuring no meaningful changes would take place.

"We manage our political risk with the same intensity that we manage our credit and interest rate risks," Fannie CEO Franklin Raines, a former Clinton official and current Barack Obama adviser, bragged to investors in 1999.

In November 2000, Clinton's HUD hailed "new regulations to provide $2.4 trillion in mortgages for affordable housing for 28.1 million families." It made Fannie and Freddie take part in the biggest federal expansion of housing aid ever.

Soon after taking office, Bush had his hands full with the Clinton recession and 9/11. But by 2003, he proposed what the New York Times called "the most significant regulatory overhaul in the housing finance industry since the savings and loan crisis a decade ago."

The plan included a new regulator for Fannie and Freddie, one that could boost capital mandates and look at how they managed risk.

Even after regulators in 2003 uncovered a scheme by Fannie and Freddie executives to overstate earnings by $10.6 billion to boost bonuses, Democrats killed reform.

"Fannie Mae and Freddie Mac are not facing any kind of financial crisis," said Rep. Frank, then-ranking Democrat on the Financial Services Committee.

North Carolina Democrat Melvin Watt accused the White House of "weakening the bargaining power of poorer families and their ability to get affordable housing."

In 2005, then-Fed Chairman Alan Greenspan told Congress: "We are placing the total financial system of the future at substantial risk."

McCain Urged Changes

That year, Sen. John McCain, one of three sponsors of a Fannie-Freddie reform bill, said: "If Congress does not act, American taxpayers will continue to be exposed to the enormous risk that Fannie Mae and Freddie Mac pose to the housing market, the overall financial system and the economy as a whole."

Sen. Harry Reid — now Majority Leader — accused the GOP of trying to "cripple the ability of Fannie Mae and Freddie Mac to carry out their mission of expanding homeownership."

The bill went nowhere.

This year, the media have repeated Democrats' talking points about this being a "Republican" disaster. Well, McCain has repeatedly called for reforming the mortgage giants. The White House has repeatedly warned Congress. This year alone, Bush urged reform 17 times.

Some GOP members are complicit. But Fannie and Freddie were created by Democrats, regulated by Democrats, largely run by Democrats and protected by Democrats.

That's why taxpayers are now being asked for $700 billion.

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OPENING ARGUMENT

When Fannie And Freddie Opened The Floodgates

MISDIAGNOSING THE CAUSES OF THE CRISIS COULD LEAD BOTH TO REGULATORY OVERKILL AND TO MORE RECKLESS RISK TAKING.

Saturday, Oct. 18, 2008
by Stuart Taylor

ADVERTISEMENT

President Bush, his Securities and Exchange Commission appointees, other free-enterprise dogmatists who have stood in the way of regulating risky and opaque financial manipulations, and greedy Wall Streeters deserve the blame heaped on them for the financial meltdown that has so severely shaken America.

But the pretense of many Democrats that this crisis is altogether a Republican creation is simplistic and dangerous.

It is simplistic because Democrats have been a big part of the problem, in part by supporting governmental distortions of the marketplace through mortgage giants Fannie Mae and Freddie Mac, whose reckless lending practices necessitated a $200 billion government rescue last month. It is dangerous because misdiagnosing the causes of the crisis could lead both to regulatory overkill and to more reckless risk taking by Fannie, Freddie, or newly created government-sponsored enterprises.

Fannie and Freddie aside, it's worth pointing out that many, if not most, of those greedy Wall Street barons are Democrats. And that the securities and investment industry has given more money to Democrats than to Republicans in this election cycle. And that opposing regulation of risky new financial practices by private investment banks and others has been a bipartisan enterprise, engaged in by the Clinton and Bush administrations alike.

But the roles of Fannie and Freddie are my focus here. Powerful Democratic (and some Republican) advocates of affordable housing, including Senate Banking, Housing, and Urban Affairs Committee Chairman Christopher Dodd, D-Conn.; Sen. Charles Schumer, D-N.Y.; and House Financial Services Chairman Barney Frank, D-Mass., have been the GSEs' most potent and ardent champions in recent years. Meanwhile, the agencies and their employees have orchestrated a gigantic lobbying effort (costing more than $174 million between 1998 and 2008). They have also made campaign contributions of more than $14.6 million between the 2000 and 2008 election cycles, with some of the largest going to Dodd and Barack Obama.

A leading illustration of this Democrat-GSE symbiosis came in summer 2005. The Senate Banking Committee adopted a bill to impose tighter regulation on Fannie and Freddie, with all Republicans voting for it. But the Democrats voted against it in committee and killed it on the floor.

Also in 2005, Fannie and Freddie began buying vast amounts of subprime and "alt-A" mortgages with, in many cases, virtually no down payments, that had been taken out by people with low credit scores and low incomes relative to their monthly payments. To finance more and more affordable housing, as leading Democrats, and some Republicans, had urged, the GSEs dramatically lowered their traditional underwriting standards.

Between 2005 and 2007, Fannie and Freddie "sold out the taxpayers" by financing almost $1 trillion in such highly risky mortgages, according to "The Last Trillion Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac," a carefully researched essay posted on the conservative American Enterprise Institute's website by Peter Wallison of AEI and Charles Calomiris of Columbia Business School.

They base their trillion-dollar figure, which is much higher than most published estimates, on detailed analysis of what they call "accounting practices that made it difficult to detect the size of those exposures."

Fannie and Freddie appear to have played a major role in causing the current crisis, in part because their quasi-governmental status violated basic principles of a healthy free enterprise system by allowing them to privatize profit while socializing risk. That is, their special privileges as GSEs -- created decades ago to promote homeownership by buying mortgages from banks, which could then use the cash to make more loans -- enabled them to lend at high rates to reap enormous profits for their private stockholders and executives and to borrow at low rates based on the government's implicit promise to rescue them from any failure, as it has now done.

> Unbeknownst to the investment banks, the experts at Fannie and Freddie knew very well that their bosses were taking reckless risks.

Many conservatives have gone so far as to blame Fannie, Freddie, and their Democratic sponsors for the entire meltdown. Some (not including Wallison and Calomiris) also blame the Community Reinvestment Act of 1977, which forced banks to lend and invest more in minority and low-income areas.

This accusation has spurred furious rebuttals by Democrats and their media friends. Some have been well reasoned. Some -- especially a July 14 column by *New York Times* columnist Paul Krugman, who was awarded the Nobel Prize in economics this week -- have been flat-out incorrect.

As Wallison and Calomiris demonstrate, Krugman was egregiously wrong in writing that "Fannie and Freddie had nothing to do with the explosion of high-risk lending." He was wrong again in stating that "they didn't do any subprime lending, because they can't ... by law." He was further wrong in writing that the GSEs were "tightly regulated with regard to the risks they can take."

Others in the don't-blame-Fannie-and-Freddie camp reasonably point out that private Wall Street investment banks and others financed even more of the $3 trillion in substandard mortgages than Fannie and Freddie did, and that these investment banks and many of the mortgage lenders who made (and then sold) the loans were not covered by the Community Reinvestment Act.

Wallison agrees that the 31-year-old law does not appear to have been a major cause of the current crisis. He also notes that although the Clinton administration pushed the GSEs to finance more affordable housing by purchasing subprime mortgages, it was not until 2005 that the GSEs began financing risky loans in huge amounts.

Why did Fannie and Freddie dive into the subprime mortgage market? And were their practices just one facet -- or the most important cause -- of the crisis? The questions are related and the answers debatable.

Freddie and then Fannie had been ravaged in 2003 and 2004 by accounting scandals that led to the departures of top executives, including Fannie Mae CEO Franklin Raines, a former Clinton administration official who had collected $90 million in compensation from 1998 through 2004. The scandals brought warnings from Alan Greenspan, then the powerful chairman of the Federal Reserve

Board, that the government should restrain the mortgage giants' growth. Meanwhile, three Fed economists published a study casting doubt on whether Fannie and Freddie had much effect on mortgage interest rates. All of this put the two agencies on the defensive in Congress.

By the time Daniel Mudd succeeded Raines in 2004, according to an in-depth *New York Times* article on October 5 by Charles Duhigg, "his company was under siege. Competitors were snatching lucrative parts of its business. Congress was demanding that Mr. Mudd help steer more loans to low-income borrowers. Lenders were threatening to sell directly to Wall Street unless Fannie bought a bigger chunk of their riskiest loans.

"So Mr. Mudd made a fateful choice," Duhigg wrote. "Disregarding warnings from his managers that lenders were making too many loans that would never be repaid, he steered Fannie into more-treacherous corners of the mortgage market, according to executives.

"For a time, that decision proved profitable. In the end, it nearly destroyed the company and threatened to drag down the housing market and the economy."

(So much for Krugman's analysis.)

Duhigg added, "The ripple effect of Fannie's plunge into riskier lending was profound. Fannie's stamp of approval made shunned borrowers and complex loans more acceptable to other lenders, particularly small and less sophisticated banks." The banks had little incentive to avoid risky loans as long as they could sell them to the GSEs and others long before any defaults.

Duhigg also implies, however, that Fannie and Freddie joined the junk-mortgage binge, rather than led it, to avoid losing business to private companies such as Bear Stearns, Lehman Brothers, and Goldman Sachs. Other analysts plausibly argue that what started the ball rolling was an August 2004 decision by the big bond-rating agencies, Moody's and Standard & Poor's, to loosen their guidelines for rating mortgage-backed securities.

Wallison and Calomiris disagree. "The most plausible explanation for the sudden adoption of this disastrous course [by Fannie and Freddie] is their desire to continue to retain the support of Congress after their accounting scandals in 2003 and 2004," they argue. In an October 15 *Wall Street Journal* op-ed, Wallison adds, without qualification, that this was "the source of the financial crisis we are wrestling with today."

But why would investment banks take foolish risks with their own money, as well as that of investors, just because Fannie and Freddie were doing so? In an interview, Wallison theorizes that the companies wrongly assumed that these must be sound investments because the leading experts on the mortgage market -- Fannie and Freddie, with their vast databases and sophisticated computer programs -- thought so. But unbeknownst to the investment banks, the experts at Fannie and Freddie knew very well that their bosses were taking reckless risks.

Perhaps a congressional investigation will someday sort out the extent to which Congress itself -- by pressuring Fannie and Freddie to take such risks -- brought about the current crisis.

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REVIEW & OUTLOOK | OCTOBER 18, 2008

Another 'Deregulation' Myth

A cautionary tale about financial rules that failed.

As we've documented the myriad ways that Washington encouraged the housing bubble, the media and Democrats continue to search for evidence to blame it all on "deregulation."

One alleged perpetrator, the Gramm-Leach-Bliley Act, was released without charges after the record revealed that Joe Biden voted for it and Bill Clinton signed it. More to the point, investment banks were already free, prior to the 1999 law, to invest in the same assets that have wreaked such havoc today.

Barack Obama nonetheless attacks President Bush's policies to "strip away regulation," without mentioning a single example. In an attempt to fill out Mr. Obama's talking points, the press corps has now fingered a 2004 change in SEC net capital rules. In fact, then-SEC Chairman William Donaldson's reform was anything but deregulation. A regulatory failure, yes, and a cautionary tale for those who think new regulation will solve everything.

The 2004 change won unanimous approval from SEC commissioners and Democrat Annette Nazareth, who ran the market regulation division at the time. Rather than deregulation, it was a breathtaking regulatory leap for an agency that had traditionally focused on protecting individual investors. Under the new program, the SEC would not simply monitor broker-dealers to ensure that client accounts were safe. The commission staff would collect new data from the parent companies of brokerages and require new monthly and quarterly reports. Firms were supposed to provide detailed explanations of internal risk models.

Before approving the rule at an April 2004 meeting, several commissioners wondered if the SEC staff was up to the task. Apparently not. It's clear from a recording of that meeting that the commission expected investment banks to employ more debt. This was no unintended consequence but the inevitable result of adopting the so-called Basel II banking standards. The SEC was supposed to apply these standards created for commercial banks to investment banks, but with additional measures to ensure liquidity.

Was Basel II a libertarian plot cooked up at the Cato Institute? Not quite. It was the product of years of effort by the world's major central banks, intended to avoid crises such as the U.S. savings and loan disaster. Basel embraced the theory that a common set of global banking standards and more intensive study of the risks of particular assets would yield both more efficient use of capital and a more stable financial system.

We now know it did not create stable investment banks, but the SEC could be forgiven for thinking that if it was good enough for the world's central bankers, it was good enough for the commission. As Ms. Nazareth said of the SEC's new approach, "It's largely modeled after Federal Reserve-type supervision and I can't imagine anyone would question that kind of approach." Few did. Swiss banking regulators are only now raising mandatory capital ratios above those permitted under Basel II.

One fair question is how such regulation could have allowed Wall Street to employ so much more debt than the commercial banks. Part of the answer is that, instead of a fixed capital ratio standard, Basel II uses mathematical models crunching historical data to determine how risky an institution's assets are and therefore how much capital it needs. For this reason, when the investment banks switched to Basel II in the middle of a housing boom, AAA-rated mortgage-backed securities appeared almost as safe as cash. Oops. The models allowed Wall Street to add too much leverage. By the same token, because risk models will now look back and see several awful years of default rates, they may force banks to be overly cautious.

News reports have played up a recent report by the SEC's Inspector General criticizing the SEC's risk supervision under the 2004 rule change. The IG also criticized the specific monitoring of Bear Stearns. But on the central question of whether the rules were enforced and applied correctly, the IG's verdict is clear: "Bear Stearns was compliant with the CSE program's capital and liquidity requirements."

We should also note that the SEC's net capital rules appear to have worked as they were originally intended throughout this crisis. Created in 1975, these regulations were explicitly to protect cash and securities in investor accounts. Sure, investment banks could fail, as Drexel Burnham Lambert did in 1990, but such failures could not be allowed to wipe out brokerage customers.

In case a firm or an individual violates the obligation, there is the Securities Investor Protection Corporation (SIPC). According to the SIPC, individual customer accounts were never in danger at Bear Stearns. As for Lehman, the paperwork challenge will take time to resolve. Lehman's more than 600,000 accounts are roughly equal to the total that SIPC has had to manage in its entire history since 1970. But so far, the SIPC reports it is processing accounts as it always does, and customers are receiving their due.

As for the SEC, if commissioners took on a massive burden in 2004 without realizing they had signed up to safeguard the world's financial system, then they overreached. But they sure didn't "deregulate."

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OPINION | OCTOBER 18, 2008

Most Pundits Are Wrong About the Bubble

The repeal of Glass-Steagall has helped us weather the storm.

By CHARLES W. CALOMIRIS

It's grind-your-favorite-axe day on the network news shows. The financial crisis is all the fault of dreaded "deregulation," shout some pundits; others blame the "small government" mentality of the Bush administration and Republicans in Congress.

But haven't federal and state tax revenues been growing even faster than home prices in most places in the U.S. over the past eight years? Hasn't the problem with our government's fiscal affairs been enormous growth in spending and entitlements not seen since the days of LBJ? Congressional Democrats -- along with a surprising number of pork-barrel Republicans -- demanded nonwar spending on a Great Society scale and the president gave in to buy their votes for the war.

As for the evils of deregulation, exactly which measures are they referring to? Financial deregulation for the past three decades consisted of the removal of deposit interest-rate ceilings, the relaxation of branching powers, and allowing commercial banks to enter underwriting and insurance and other financial activities. Wasn't the ability for commercial and investment banks to merge (the result of the 1999 Gramm-Leach-Bliley Act, which repealed part of the 1933 Glass-Steagall Act) a major stabilizer to the financial system this past year? Indeed, it allowed Bear Stearns and Merrill Lynch to be acquired by J.P. Morgan Chase and Bank of America, and allowed Goldman Sachs and Morgan Stanley to convert to bank holding companies to help shore up their positions during the mid-September bear runs on their stocks.

Even more to the point, subprime lending, securitization and dealing in swaps were all activities that banks and other financial institutions have had the ability to engage in all along. There is no connection between any of these and deregulation. On the contrary, it was the ever-growing Basel Committee rules for measuring bank risk and allocating capital to absorb that risk (just try reading the Basel standards if you don't believe me) that failed miserably. The Basel rules outsourced the measurement of risk to ratings agencies or to the modelers within the banks themselves. Incentives were not properly aligned, as those that measured risk profited from underestimating it and earned large fees for doing so.

That ineffectual, Rube Goldberg apparatus was, of course, the direct result of the politicization of prudential regulation by the Basel Committee, which was itself the direct consequence of pursuing "international coordination" among countries, which produced rules that work politically but not economically. International cooperation, in case you haven't heard, is exactly what the French and the Germans now say was missing in the past few years.

So why blame deregulation and small government? The social psychologist Gustav Jahoda says that unreasonable beliefs often arise in circumstances where people lack control and need to believe in something to get them through a highly stressful situation. And a fellow named Machiavelli might help us to understand a different reason for simplistic explanations.

Here is the non-stress-relieving truth. Severe financial crises have occurred in many countries -- roughly 100 over the past 30 years -- and even on a global scale many times before. About 2,000 years ago, Tiberius solved an early global financial crisis by making huge zero-interest loans to Roman banks. Sound familiar? These unusual events often reflect a confluence of different circumstances; for the most part they are not the inevitable result of a single, foreseeable fault in the system.

So what really happened and what should we do to make things better? The current financial crisis, like many in the past, had its roots in several areas: loose monetary policy (from 2002-2005, the real fed-funds rate was persistently negative to a degree not seen since the mid-1970s); government subsidies for leverage in real estate (the list is a long one, but the government's role in Fannie and Freddie tops it); and many other errors by the public and private sector, including longstanding flaws in prudential regulation (see aforementioned Basel rules).

As we try to devise solutions to the regulatory problems, there is plenty of room for improvement and lots of sensible ideas about how to proceed -- all of which have been around for a long time. The single most important reform that is needed is the restoration of discipline in the measurement of risk within the banking system.

Academics have been calling for reforms -- especially a minimum subordinated debt requirement that would create ongoing, market-based measurement of true bank risk -- for many years. In fact, a study of that reform was mandated by the Gramm-Leach-Bliley Act of 1999. Although the study by the Federal Reserve indicated that the reform would be extremely helpful, the big banks successfully lobbied to avoid the imposition of discipline on their risk taking.

The starting point for reform is to begin with a dispassionate and informed assessment of what happened. History is messy, and the careful study of facts offers little satisfaction for one-note Johnnies. It's easier to just invent one's own history than to study the real thing (which may explain why invention is so much more popular).

All this reminds me of an old Doonesbury comic strip in which a history teacher tries to shock his class by telling them outrageous made-up facts, only to find that they finally seem to be taking notes. Neither Jahoda nor Machiavelli would be surprised.

Mr. Calomiris, a professor at Columbia Business School, is the author of "U.S. Bank Deregulation in Historical Perspective" (Cambridge University Press, 2006).

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October 21, 2008

The Honorable Christopher Dodd
Chairman
Committee on Banking, Housing and Urban Development
United States Senate
Washington, DC 20510

The Honorable Richard Shelby
Ranking Member
Committee on Banking, Housing and Urban Development
United States Senate
Washington, DC 20510

The Honorable Barney Frank
Chairman
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Dear Chairmen Dodd and Frank and Ranking Members Shelby and Bachus:

As you begin consideration of economic recovery legislation, I am writing on behalf of the Credit Union National Association (CUNA) to encourage you to consider enhancing ability of credit unions to be part of the solution. CUNA is the nation's largest credit union advocacy organization, representing 90% of our nation's approximately 8,300 state and federal credit unions, which serve over 90 million members, and state credit union leagues.

Credit Unions Should Be Part of the Solution for Consumers and Small Businesses

For nearly a century, in both good times as well as bad, credit unions in the United States have been there for consumers. In the aftermath of the Great Depression, Congress created the federal credit union charter to make credit more available to American consumers and help stabilize the credit structure of the United States. As the economy recovers from this crisis, credit unions will continue to be there for our members. We know credit unions cannot be the entire solution to the problems our economy faces, but we remain an important resource to credit union members; and data suggests that the existence of a strong credit union movement benefits all consumers.

With that in mind, we bring to your attention several statutory changes that we believe should be considered as part of an economic recovery plan. These recommendations focus on maintaining credit unions strong capital levels by implementing robust regulatory tools and restoring credit unions' ability to fully meet the needs of their small business members during and after the credit crunch.

Enhancements to Credit Union Net Worth and Capital Requirements Are Necessary

As a result of the recent failures of Indymac Bank and Washington Mutual, some credit unions, particularly on the West Coast, have seen an influx in deposits. The Federal Credit Union Act prescribes rigid capital requirements for credit unions that are enumerated in law. Of all the capital requirements that apply to insured depository institutions in this county (banks, thrifts, and credit unions), the credit union standards are by far the most stringent, because they are (1) the only ones embedded in a statute, rather than a regulation that can more easily be modified as circumstances change; (2) the highest, requiring 7% net worth in order to qualify as "well capitalized"; and (3) the narrowest in terms of what "counts" as capital (only retained earnings, and nothing else, makes the grade). This gives the National Credit Union Administration (NCUA) very little flexibility to adjust the capital level for credit unions or to take into consideration unanticipated circumstances and can place credit unions in a straitjacket when savings inflows suddenly occur.

There are a number of ways for a credit union to manage an unexpected influx of funds, including lowering the rate on new deposits; however, in some cases, the only alternative is to cease the intake of deposits. A very well capitalized credit union can see its net worth ratio decrease if it takes in a large amount of unplanned funds. Such circumstances have a disproportionately adverse impact on small and medium sized credit unions which can see net worth ratios decline rapidly as a result of just a small number of large deposits. During these difficult economic times and with uncertainty surrounding many banks, it would be an absolute travesty for any credit union to have to display "no deposit" signs in its lobby.

Permit All Credit Unions to Accept Secondary Capital
Last week, the Administration announced a capital purchase program for banks, under the authority Congress extended through the enactment of the Emergency Economic Stabilization Act of 2008. Despite the intention of Congress for the funds provided under this Act to be available broadly to financial institutions, including credit unions, most credit unions are not eligible to participate in the capital purchase program because the Federal Credit Union Act permits only low-income and corporate credit unions to accept secondary capital.

Credit unions, as an industry, are well-capitalized with an industry average of around 11%. However, the ability for credit unions to draw on additional capital, if needed, would be an important source of strength for individual credit unions and possibly for the entire credit union system. Therefore, we encourage Congress to give credit unions an additional tool on a temporary basis to manage these circumstances by enacting legislation that would permit all credit unions to acquire secondary, subordinate capital if they choose. This temporary acquisition authority would give credit unions an important tool to address unanticipated effects of the economic crisis and it would permit credit unions, as needed, to have equal access to the remedies proposed by the Department of Treasury.

Authorize NCUA to Implement a Risk-Based Capital System for Credit Unions
For the past six years, credit unions have been encouraging Congress to pass legislation that would allow NCUA to implement a risk-based capital system for credit unions. The approach that we favor, which is Title I of H.R. 1537, was developed by NCUA and would help credit unions to better manage unexpected circumstances. Incidentally, banks operate under a similar risk-based capital system.

The Prompt Corrective Action system in place for credit unions is imprecise. Moving to capital standards that more accurately reflect risk will serve to strengthen credit unions and better protect the National Credit Union Share Insurance Fund.

Credit Unions Are Well Positioned to Assist Main Street

The consequences of the economic crisis are beginning to affect Main Street. Small business owners are finding it increasingly more difficult to secure the credit that they need to keep their businesses operational. Identifying mechanisms to ensure the continued availability of credit for America's small businesses is critically important.

Earlier this month, Senator Schumer proposed creating a federal emergency loan program for small business loans.[1] We suggest a complementary approach which would benefit small business owners without putting additional taxpayer funds in jeopardy: the elimination of the decade-old cap on credit union member business lending.

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[1] "Schumer Calls For Emergency Business Loans," Inc.com. October 8, 2008. http://www.inc.com/news/articles/2008/10/emergency-loans.html.

Credit unions have been serving the business lending needs of their members since their inception in the United States nearly 100 years ago. Prior to 1998, there was no statutory limit on a credit union's outstanding business lending portfolio; however, through the enactment of the Credit Union Membership Access Act of 1998, Congress capped credit union member business lending at 12.25% of total assets.

Credit unions with business lending experience are in a position to assist small business owners. There are currently $30 billion of outstanding credit union member business loans. We estimate that in an environment in which credit unions are no longer restricted by a statutory business lending cap and are encouraged by the regulator to lend money to their small business-owning members in a safe and sound manner, credit unions could easily lend an additional $10 billion in the next twelve months.

While eliminating the credit union business lending cap will not completely solve the credit crisis facing small businesses, it does represent a mechanism that will provide much needed relief to America's small businesses without costing taxpayers a dime. We hope you will seriously consider this as you prepare the economic recovery legislation.

On behalf of the 90 million members of America's state and federally chartered credit unions, we appreciate your consideration and look forward to working with Congress and the Administration to ensure credit unions are able to do their part to facilitate economic recovery.

Sincerely,

Daniel A. Mica

Daniel A. Mica
President & CEO

cc: The Honorable Charles Schumer, United States Senate

NAFCU
National Association of Federal Credit Unions
3138 10th Street North • Arlington, Virginia • 22201-2149
(703) 522-4770 • (800) 336-4644 • Fax (703) 522-2734

Fred R. Becker, Jr.
President and CEO

October 20, 2008

The Honorable Barney Frank
Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Frank and Ranking Member Bachus:

I am writing on behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the interests of our nation's federal credit unions, in conjunction with your upcoming hearing entitled "Regulatory Restructuring and Reform of the Financial System."

The mortgage practices that caused the subprime crisis stand in stark contrast to the credit union guiding principle of "people helping people." NAFCU is pleased that credit unions did not cause the turmoil in the housing market, which has led to this deepening crisis. This was due in part to the oversight that the National Credit Union Administration (NCUA) provided the credit union community. We believe that the unique nature of credit unions as member-owned, not-for-profit cooperatives warrants an independent regulator that recognizes these unique characteristics and is singularly focused on maintaining the safety and soundness of the industry. NAFCU therefore emphasizes the importance of federal credit unions continuing to be subject to regulatory oversight by an independent agency that recognizes the special nature of credit unions. Even though the current economic meltdown has impacted everyone, we believe the fact that credit unions were not responsible for the economic turmoil is testament to the current framework of having an independent regulator for credit unions.

Credit unions did not cause this crisis, but our members recognize that it is important to be part of the solution. Credit unions are inherently invested in their communities and stand ready to help in these troubling economic times. Our member credit unions continue to strive to best serve their members, however, some challenges remain.

E-mail: fbecker@nafcu.org • **Web site:** www.nafcu.org

The Honorable Barney Frank
The Honorable Spencer Bachus
October 20, 2008
Page 2

Unlike other financial institutions, credit unions do not have a capital system that appropriately accounts for risk. A modernized risk-based capital system that would more closely emulate the capital standards for FDIC-insured banks would better enable NCUA to assign more appropriate capital standards to credit unions based on their risk.

Additionally, in this current credit crunch, credit unions would like to provide members with more access to capital. It is disappointing that given the current economic environment where capital is limited, the arbitrary member business lending cap placed on credit unions over a decade ago remains in place. A 2001 Treasury Department report indicated that credit union business lending meets the needs of America's small businesses that other institutions are unable to serve. This statement rings true even more so today in the midst of the current credit crunch that we are facing. A slight modification of the current cap of 12.25% of assets to 20% of assets would allow credit unions to lend millions more to our nation's small businesses and help stimulate the economy, at no cost to the taxpayer.

NAFCU appreciates the opportunity to share our thoughts on this important topic and on opportunities for credit unions to do more to be part of the solution. We look forward to working with you and your staff as the committee continues to address the current crisis. Should you have any questions or require any additional information please do not hesitate to contact me or Brad Thaler, NAFCU's Director of Legislative Affairs at 703-522-4770.

Sincerely,

Fred R. Becker, Jr.
President/CEO

cc: Members of the House Committee on Financial Services

NASCUS

Submission for the Record
To the House Financial Services Committee
Hearing on Financial Regulation
National Association of State Credit Union Supervisors (NASCUS)
October 21, 2008

The National Association of State Credit Union Supervisors (NASCUS)[1] appreciates the opportunity to provide a submission for the record to the House Financial Services Committee Hearing on Financial Regulation on behalf of the NASCUS Board of Directors. NASCUS has been committed to enhancing state credit union supervision and advocating for a safe and sound state credit union system since its inception in 1965. NASCUS is the sole organization dedicated exclusively to the promotion of the dual chartering system and advancing the autonomy and expertise of state credit union regulatory agencies.

NASCUS understands that the Committee will review broad regulatory restructuring and reform, including financial institution oversight and regulation. As you consider regulatory reform in the current economic environment, please do not overlook the importance of financial institutions having access to capital. Capital reform is an important part of regulatory reform for credit unions and is crucial to safety and soundness.

NASCUS has long been a proponent of complete capital reform for credit unions. Credit unions need access to supplemental capital and risk-based capital requirements; these related but distinctly different concepts are not mutually exclusive. The current economic environment necessitates that now is the time for capital reform for credit unions.

[1] NASCUS is the professional association of state credit union regulatory agencies that charter, examine and supervise the nation's 3,300 state-chartered credit unions.

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Access to Supplemental Capital

Access to supplemental capital for credit unions is an issue of safety and soundness. Supplemental capital would allow credit unions further flexibility in changing economic environments. Unlike other financial institutions, credit union access to capital is limited to the set aside of reserves and retained earnings from net income. Credit unions need a capital system that allows them to react more quickly and to strengthen net worth beyond the accumulation of retained earnings, which takes time and is not always feasible in a fast-changing environment. Supplemental capital provides credit unions the ability to plan and respond proactively to changing market conditions, enhancing their future viability and strengthening their safety and soundness.

In addition, in times of economic instability, credit unions need capital to protect and grow liquidity. Liquidity is crucial to credit unions' continued success in meeting their member lending needs.

Supplemental capital is not new to the credit union system; several models are already in use. Low-income credit unions are authorized to raise uninsured secondary capital. Corporate credit unions have access, too; they have both membership capital shares and permanent capital accounts, known as paid-in capital. These models work and could be adjusted for natural-person credit unions accordingly.

Supplemental capital provides additional protection for the National Credit Union Share Insurance Fund (NCUSIF) and minimizes exposure to taxpayers–this is critical. Federally insured credit unions recapitalized the NCUSIF in 1985 by depositing an amount equal to one percent of their insured shares into the Share Insurance Fund. This concept is unique to the credit union system; no federal tax dollars have ever been used for the fund and no member has lost money insured by the NCUSIF. Allowing credit unions access to other methods of raising capital provides an additional layer of protection to the insurance fund.

Risk-Based Capital for Credit Unions

Today, every insured depository institution, with the exception of credit unions, uses risk-based capital requirements to build and monitor capital levels. Risk-based capital requirements enable financial institutions to better measure capital adequacy and avoid excessive risk on their balance sheets. A risk-based capital system acknowledges the diversity and complexity between financial institutions. It requires increased capital levels for financial institutions that choose to maintain a more complex balance sheet, while reducing the burden of capital requirements for institutions holding less complex assets. This system recognizes that a one-size fits all capital system does not work.

The financial community continues to refine risk-based capital measures as a logical and important part of evaluating and quantifying capital adequacy. Credit unions are the only insured depository institutions not allowed to use risk-based capital measures as presented in the Basel Accord of 1988. A risk-based capital regime would require credit unions to more effectively monitor risks in their balance sheets. It makes sense that credit unions should have access to risk-based capital; it is a practical and necessary step in addressing capital reform for credit unions.

In closing, while credit unions remain safe and sound in this troubled and volatile market, capital reform will enhance their ability to react to market conditions, grow safely into the future and serve citizens in local communities in time of economic trouble.

NASCUS is pleased to have the opportunity to submit written testimony to the House Financial Service Committee regarding the Regulatory Reform Hearing. We appreciate your time studying our concerns; we are available for dialogue, to answer questions and look forward to the opportunity to testify on capital reform as well as regulatory restructuring for credit unions at a future date. The current economic environment highlights the need for timely and comprehensive capital reform for credit unions.

Bill Summary & Status

Amendments For H.R.1461

1-9 of 9

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Amendments For H.R.1461

1.H.AMDT.596 to H.R.1461
Title: Manager's amendment consists of the text of the amendment contained in House Report 109-254 and printed on pages H9172-H9175 in the Congressional Record for Oct. 26, 2005.
Sponsor: Rep Oxley, Michael G. [R-OH-4] (introduced 10/26/2005) **Cosponsors:** (none)
Latest Major Action: 10/26/2005 House amendment agreed to. Status: On agreeing to the Oxley amendment (A001) Agreed to by recorded vote: 210 - 205 (Roll no. 541).

2.H.AMDT.597 to H.R.1461
Title: Amendment encourages Government Sponsored Enterprises (GSEs) to purchase personal property loans secured by manufactured housing that will count towards the GSE underserved market goals.
Sponsor: Rep Carson, Julia [D-IN-7] (introduced 10/26/2005) **Cosponsors:** (none)
Latest Major Action: 10/26/2005 House amendment agreed to. Status: On agreeing to the Carson amendment (A002) Agreed to by voice vote.

3.H.AMDT.598 to H.R.1461
Title: Amendment clarifies the definition of "rural" in the bill to make it consistent with the same definition in the Housing Act of 1949 with the inclusion of language concerning micropolitan areas and tribal trust lands.
Sponsor: Rep Davis, Artur [D-AL-7] (introduced 10/26/2005) **Cosponsors:** (none)
Latest Major Action: 10/26/2005 House amendment agreed to. Status: On agreeing to the Davis (AL) amendment (A003) Agreed to by voice vote.

4.H.AMDT.599 to H.R.1461
Title: Amendment sought to replace the language in the bill concerning minimum capital levels.
Sponsor: Rep Leach, James A. [R-IA-2] (introduced 10/26/2005) **Cosponsors:** (none)
Latest Major Action: 10/26/2005 House amendment not agreed to. Status: On agreeing to the Leach amendment (A004) Failed by recorded vote: 36 - 378 (Roll no. 542).

5.H.AMDT.600 to H.R.1461
Title: Amendment sought to authorize the regulator to require one or both of the GSEs to dispose or acquire assets or liabilities if the regulator deems those assets or liabilities to be a potential systemic risk to the housing or capital markets, or the financial system.
Sponsor: Rep Royce, Edward R. [R-CA-40] (introduced 10/26/2005) **Cosponsors:** (none)
Latest Major Action: 10/26/2005 House amendment not agreed to. Status: On agreeing to the Royce

amendment (A005) Failed by recorded vote: 73 - 346 (Roll no. 543).

6.H.AMDT.601 to H.R.1461
Title: Amendment sought to eliminate the ability of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank Board, to borrow from the Treasury.
Sponsor: Rep Paul, Ron [R-TX-14] (introduced 10/26/2005) **Cosponsors:** (none)
Latest Major Action: 10/26/2005 House amendment not agreed to. Status: On agreeing to the Paul amendment (A006) Failed by recorded vote: 47 - 371 (Roll no. 544).

7.H.AMDT.602 to H.R.1461
Title: Amendment sought to strike the language in the bill that raises the Conforming Loan Limit for certain areas.
Sponsor: Rep Garrett, Scott [R-NJ-5] (introduced 10/26/2005) **Cosponsors:** (none)
Latest Major Action: 10/26/2005 House amendment not agreed to. Status: On agreeing to the Garrett (NJ) amendment (A007) Failed by recorded vote: 57 - 358 (Roll no. 545).

8.H.AMDT.603 to H.R.1461
Title: Amendment adds alternative credit scoring as an element of the Annual Housing Report Regarding Regulated Entities required by the bill.
Sponsor: Rep Sanchez, Loretta [D-CA-47] (introduced 10/26/2005) **Cosponsors:** (none)
Latest Major Action: 10/26/2005 House amendment agreed to. Status: On agreeing to the Sanchez, Loretta amendment (A008) Agreed to by voice vote.

9.H.AMDT.604 to H.R.1461
Title: Amendment restores the Presidential and regulatory board appointment systems for Government Sponsored Enterprises (GSEs) while preserving changes made by the bill including providing flexibility in the size of corporate boards at Fannie Mae and Freddie Mac and lengthening the terms of service at the Federal home loan banks.
Sponsor: Rep Kanjorski, Paul E. [D-PA-11] (introduced 10/26/2005) **Cosponsors:** (none)
Latest Major Action: 10/26/2005 House amendment agreed to. Status: On agreeing to the Kanjorski amendment (A009) Agreed to by voice vote.

COMMITTEE VOTES

Clause 3(b) of rule XIII of the Rules of the House of Representatives requires the Committee to list the record votes on the motion to report legislation and amendments thereto. A motion by Mr. Oxley to report the bill, with an amendment, to the House with a favorable recommendation was agreed to by a record vote of 65 yeas and 5 nays (Record vote no. FC-5). The names of Members voting for and against follow:

RECORD VOTE NO. FC-5

Representative	Aye	Nay	Representative	Aye	Nay
Mr. Oxley	X		Mr. Frank (MA)	X	
Mr. Leach	X		Mr. Kanjorski	X	
Mr. Baker	X		Ms. Waters	X	
Ms. Pryce (OH)	X		Mr. Sanders	X	
Mr. Bachus	X		Mrs. Maloney	X	
Mr. Castle	X		Mr. Gutierrez	X	
Mr. King (NY)	X		Ms. Velazquez	X	
Mr. Royce		X	Mr. Watt	X	
Mr. Lucas	X		Mr. Ackerman	X	
Mr. Ney	X		Ms. Hooley	X	
Mrs. Kelly	X		Ms. Carson	X	
Mr. Paul		X	Mr. Sherman	X	
Mr. Gillmor	X		Mr. Meeks (NY)	X	
Mr. Ryun (KS)	X		Ms. Lee	X	
Mr. LaTourette	X		Mr. Moore (KS)	X	
Mr. Manzullo	X		Mr. Capuano	X	
Mr. Jones (NC)	X		Mr. Ford	X	
Mrs. Biggert	X		Mr. Hinojosa	X	
Mr. Shays	X		Mr. Crowley	X	
Mr. Fossella	X		Mr. Clay	X	
Mr. Gary G. Miller (CA)	X		Mr. Israel	X	
Mr. Tiberi	X		Mrs. McCarthy	X	
Mr. Kennedy (MN)	X		Mr. Baca	X	
Mr. Feeney		X	Mr. Matheson	X	
Mr. Hensarling		X	Mr. Lynch	X	
Mr. Garrett (NJ)		X	Mr. Miller (NC)	X	
Ms. Brown-Waite (FL)	X		Mr. Scott (GA)	X	
Mr. Barrett (SC)	X		Mr. Davis (AL)	X	
Ms. Harris	X		Mr. Al Green (TX)	X	
Mr. Renzi	X		Mr. Cleaver	X	
Mr. Gerlach	X		Ms. Bean	X	
Mr. Pearce	X		Ms. Wasserman Schultz	X	
Mr. Neugebauer	X		Ms. Moore (WI)	X	
Mr. Price (GA)	X				
Mr. Fitzpatrick (PA)	X				
Mr. Davis (KY)	X				
Mr. McHenry	X				

The following amendments were considered by record votes. The names of Members voting for and against follow:

Mr. Oxley		X	Mr. Frank (MA)		X
Mr. Leach	X		Mr. Kanjorski		X
Mr. Baker	X		Ms. Waters		X
Ms. Pryce (OH)		X	Mr. Sanders		X
Mr. Bachus		X	Mrs. Maloney		X
Mr. Castle		X	Mr. Gutierrez		X
Mr. King (NY)		X	Ms. Velazquez		X
Mr. Royce	X		Mr. Watt		X
Mr. Lucas	X		Mr. Ackerman		X
Mr. Ney		X	Ms. Hooley		X
Mrs. Kelly		X	Ms. Carson		X
Mr. Paul	X		Mr. Sherman		X
Mr. Gillmor	X		Mr. Meeks (NY)		X
Mr. Ryun (KS)		X	Ms. Lee		X
Mr. LaTourette		X	Mr. Moore (KS)		X
Mr. Manzullo		X	Mr. Capuano		X
Mr. Jones (NC)	X		Mr. Ford		X
Mrs. Biggert		X	Mr. Hinojosa		X
Mr. Shays	X		Mr. Crowley		X
Mr. Fossella		X	Mr. Clay		X
Mr. Gary G. Miller (CA)		X	Mr. Israel		X
Mr. Tiberi		X	Mrs. McCarthy		X
Mr. Kennedy (MN)		X	Mr. Baca		X
Mr. Feeney	X		Mr. Matheson		X
Mr. Hensarling	X		Mr. Lynch		X
Mr. Garrett (NJ)	X		Mr. Miller (NC)		X
Ms. Brown-Waite (FL)		X	Mr. Scott (GA)		X
Mr. Barrett (SC)		X	Mr. Davis (AL)		X
Ms. Harris		X	Mr. Al Green (TX)		X
Mr. Renzi		X	Mr. Cleaver		X
Mr. Gerlach		X	Ms. Bean		X
Mr. Pearce	X		Ms. Wasserman Schultz		X
Mr. Neugebauer		X	Ms. Moore (WI)		X
Mr. Price (GA)	X				
Mr. Fitzpatrick (PA)		X			
Mr. Davis (KY)		X			
Mr. McHenry	X				

An amendment to the amendment in the nature of a substitute by Mr. Royce, No. 11, striking the Affordable Housing Fund was NOT AGREED TO by a record vote of 17 yeas and 53 nays (FC-3).

RECORD VOTE NO. FC-3

Representative	Aye	Nay	Representative	Aye	Nay
Mr. Oxley		X	Mr. Frank (MA)		X
Mr. Leach		X	Mr. Kanjorski		X
Mr. Baker	X		Ms. Waters		X
Ms. Pryce (OH)	X		Mr. Sanders		X
Mr. Bachus	X		Mrs. Maloney		X
Mr. Castle		X	Mr. Gutierrez		X
Mr. King (NY)		X	Ms. Velazquez		X
Mr. Royce	X		Mr. Watt		X
Mr. Lucas	X		Mr. Ackerman		X

Mr. Ney		X	Ms. Hooley		X
Mrs. Kelly		X	Ms. Carson		X
Mr. Paul	X		Mr. Sherman		X
Mr. Gillmor		X	Mr. Meeks (NY)		X
Mr. Ryun (KS)	X		Ms. Lee		X
Mr. LaTourette		X	Mr. Moore (KS)		X
Mr. Manzullo	X		Mr. Capuano		X
Mr. Jones (NC)	X		Mr. Ford		X
Mrs. Biggert		X	Mr. Hinojosa		X
Mr. Shays		X	Mr. Crowley		X
Mr. Fossella		X	Mr. Clay		X
Mr. Gary G. Miller (CA)		X	Mr. Israel		X
Mr. Tiberi		X	Mrs. McCarthy		X
Mr. Kennedy (MN)		X	Mr. Baca		X
Mr. Feeney	X		Mr. Matheson		X
Mr. Hensarling	X		Mr. Lynch		X
Mr. Garrett (NJ)	X		Mr. Miller (NC)		X
Ms. Brown-Waite (FL)	X		Mr. Scott (GA)		X
Mr. Barrett (SC)	X		Mr. Davis (AL)		X
Ms. Harris		X	Mr. Al Green (TX)		X
Mr. Renzi		X	Mr. Cleaver		X
Mr. Gerlach		X	Ms. Bean		X
Mr. Pearce	X		Ms. Wasserman Schultz		X
Mr. Neugebauer		X	Ms. Moore (WI)		X
Mr. Price (GA)	X				
Mr. Fitzpatrick (PA)		X			
Mr. Davis (KY)		X			
Mr. McHenry	X				

An amendment to the amendment in the nature of a substitute by Mr. Frank, No. 1o, establishing a Federal Housing Finance Oversight Board as the regulator was NOT AGREED TO by a record vote of 33 yeas and 37 nays (FC-4).

RECORD VOTE NO. FC-4

Representative	Aye	Nay	Representative	Aye	Nay
Mr. Oxley		X	Mr. Frank (MA)	X	
Mr. Leach		X	Mr. Kanjorski	X	
Mr. Baker		X	Ms. Waters	X	
Ms. Pryce (OH)		X	Mr. Sanders	X	
Mr. Bachus		X	Mrs. Maloney	X	
Mr. Castle		X	Mr. Gutierrez	X	
Mr. King (NY)		X	Ms. Velazquez	X	
Mr. Royce		X	Mr. Watt	X	
Mr. Lucas		X	Mr. Ackerman	X	
Mr. Ney		X	Ms. Hooley	X	
Mrs. Kelly		X	Ms. Carson	X	
Mr. Paul		X	Mr. Sherman	X	
Mr. Gillmor		X	Mr. Meeks (NY)	X	
Mr. Ryun (KS)		X	Ms. Lee	X	
Mr. LaTourette		X	Mr. Moore (KS)	X	
Mr. Manzullo		X	Mr. Capuano	X	
Mr. Jones (NC)		X	Mr. Ford	X	
Mrs. Biggert		X	Mr. Hinojosa	X	

Mr. Shays	X	Mr. Crowley	X
Mr. Fossella	X	Mr. Clay	X
Mr. Gary G. Miller (CA)	X	Mr. Israel	X
Mr. Tiberi	X	Mrs. McCarthy	X
Mr. Kennedy (MN)	X	Mr. Baca	X
Mr. Feeney	X	Mr. Matheson	X
Mr. Hensarling	X	Mr. Lynch	X
Mr. Garrett (NJ)	X	Mr. Miller (NC)	X
Ms. Brown-Waite (FL)	X	Mr. Scott (GA)	X
Mr. Barrett (SC)	X	Mr. Davis (AL)	X
Ms. Harris	X	Mr. Al Green (TX)	X
Mr. Renzi	X	Mr. Cleaver	X
Mr. Gerlach	X	Ms. Bean	X
Mr. Pearce	X	Ms. Wasserman Schultz	X
Mr. Neugebauer	X	Ms. Moore (WI)	X
Mr. Price (GA)	X		
Mr. Fitzpatrick (PA)	X		
Mr. Davis (KY)	X		
Mr. McHenry	X		

The following other amendments were also considered by the Committee:

An amendment in the nature of a substitute by Mr. Oxley, No. 1, making various substantive and technical changes to the bill, was AGREED TO, as amended, by a voice vote.

An en bloc amendment to the amendment in the nature of a substitute by Mr. Oxley, No. 1a, was AGREED TO by a voice vote.

An amendment to the amendment in the nature of a substitute by Mr. Gillmor, No. 1b, regarding disclosure of charitable contributions was AGREED TO by a voice vote.

An amendment to the amendment in the nature of a substitute by Mr. Gutierrez, No. 1c, regarding single family housing subgoals was AGREED TO by a voice vote.

An amendment to the amendment in the nature of a substitute by Mr. Bachus, No. 1d, requiring a guarantee fee study was AGREED TO by a voice vote.

An amendment to the amendment in the nature of a substitute by Mr. Royce, No. 1f, establishing a FHFA ombudsman was WITHDRAWN.

An amendment to the amendment in the nature of a substitute by Mr. Davis of Alabama, No. 1g, requiring an annual housing report was AGREED TO, as modified, by a voice vote.

An amendment to the amendment in the nature of a substitute by Mr. Leach, No. 1i, regarding GSE mission oversight had a point of order sustained against its consideration.

An amendment to the amendment in the nature of a substitute by Mr. Royce, No. 1j, regarding Federal Financial Institutions Examination Council membership was AGREED TO by a voice vote.

An amendment to the amendment in the nature of a substitute by Mr. Meeks, No. 1k, eliminating interest rate disparities was AGREED TO, as modified, by a voice vote.

An amendment to the amendment in the nature of a substitute by Ms. Waters, No. 1m, placing a limitation on subgrants was AGREED TO by a voice vote.

An amendment to the amendment in the nature of a substitute by Mr. Renzi, No. 1n, modifying the definition of rural was AGREED TO by a voice vote.

An amendment to the amendment in the nature of a substitute by Mr. McHenry, No. 1p, requiring a GSE study was WITHDRAWN.

An amendment to the amendment in the nature of a substitute by Mr. Gutierrez, No. 1q, regarding liability for certain reports of fraudulent financial transactions was AGREED TO, as modified, by voice vote.

An amendment to the amendment in the nature of a substitute by Mr. Garrett, No. 1r, establishing portfolio limitations was WITHDRAWN.

An amendment to the amendment in the nature of a substitute by Mr. Gerlach, No. 1s, requiring a study of affordable housing program use for long-term care facilities was AGREED TO by a voice vote.

An amendment to the amendment in the nature of a substitute by Mr. Royce, No. 1t, striking age limitations on enterprise boards of directors was AGREED TO by a voice vote.

An amendment to the amendment in the nature of a substitute by Mr. Hensarling, No. 1u, requiring a study of alternative secondary market systems was AGREED TO by a voice vote.

An amendment to the amendment in the nature of a substitute by Mr. Pearce, No. 1v, requiring recipient reports, was WITHDRAWN.

COMMITTEE OVERSIGHT FINDINGS

Pursuant to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the Committee held a hearing and made findings that are reflected in this report.

PERFORMANCE GOALS AND OBJECTIVES

Pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee establishes the following performance related goals and objectives for this legislation:

The Federal Housing Finance Agency will oversee the safe and sound operation as well as the mission functions of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System. The Agency will be equipped with the tools and powers possessed by a world class financial regulator. The Agency will ensure that the GSEs do not pose a significant risk to the domestic or international financial system.

NEW BUDGET AUTHORITY, ENTITLEMENT AUTHORITY, AND TAX EXPENDITURES

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee adopts as its own the estimate of new budget authority, entitlement authority, or tax expenditures or revenues contained in the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act.

COMMITTEE COST ESTIMATE

The Committee adopts as its own the cost estimate prepared by the Director

109th

FINAL VOTE RESULTS FOR ROLL CALL 542

(Republicans in roman; Democrats in *italic*; Independents underlined)

H R 1461 RECORDED VOTE 26-Oct-2005 3:06 PM
AUTHOR(S): Leach of Iowa Amendment
QUESTION: On Agreeing to the Amendment

	AYES	NOES	PRES	NV
REPUBLICAN	31	190		9
DEMOCRATIC	5	187		10
INDEPENDENT		1		
TOTALS	36	378		19

---- AYES 36 ---

Beauprez	Gillmor	Paul
Blackburn	Gutknecht	Pence
Chocola	Hensarling	Petri
Cooper	Hostettler	Rohrabacher
Dicks	Johnson (CT)	Royce
Dingell	King (IA)	Ryan (WI)
Duncan	Kingston	Shadegg
Ehlers	Latham	Shays
Flake	Leach	*Taylor (MS)*
Franks (AZ)	Lungren, Daniel E.	Taylor (NC)
Garrett (NJ)	Musgrave	Wamp
Gilchrest	Nussle	*Wynn*

---- NOES 378 ---

Abercrombie	*Gonzalez*	*Neal (MA)*
Ackerman	Goode	Neugebauer
Aderholt	Goodlatte	Ney
Akin	*Gordon*	Northup
Alexander	Granger	Norwood
Allen	Graves	Nunes
Andrews	Green (WI)	*Oberstar*
Baca	*Green, Al*	*Obey*
Bachus	*Green, Gene*	*Olver*
Baird	*Grijalva*	*Ortiz*
Baker	*Gutierrez*	Osborne
Baldwin	Hall	Otter
Barrett (SC)	*Harman*	*Owens*
Barrow	Harris	Oxley
Bartlett (MD)	Hart	*Pallone*

Barton (TX)	*Hastings (FL)*	*Pascrell*
Bass	Hastings (WA)	*Pastor*
Bean	Hayes	*Payne*
Becerra	Hayworth	Pearce
Berkley	Hefley	*Pelosi*
Berry	Herger	*Peterson (MN)*
Biggert	*Herseth*	Peterson (PA)
Bilirakis	*Higgins*	Pickering
Bishop (NY)	*Hinchey*	Pitts
Bishop (UT)	*Hinojosa*	Poe
Blumenauer	Hobson	Pombo
Blunt	Hoekstra	*Pomeroy*
Boehlert	*Holden*	Porter
Boehner	*Holt*	Price (GA)
Bonilla	*Honda*	*Price (NC)*
Bonner	*Hooley*	Pryce (OH)
Bono	*Hoyer*	Putnam
Boozman	Hulshof	Radanovich
Boren	Hunter	*Rahall*
Boucher	Hyde	Ramstad
Boustany	Inglis (SC)	*Rangel*
Boyd	*Inslee*	Regula
Bradley (NH)	*Israel*	Rehberg
Brady (PA)	Issa	Reichert
Brady (TX)	Istook	Renzi
Brown (OH)	*Jackson (IL)*	Rogers (AL)
Brown (SC)	*Jackson-Lee (TX)*	Rogers (KY)
Brown, Corrine	*Jefferson*	Rogers (MI)
Burgess	Jenkins	*Ross*
Burton (IN)	Jindal	*Rothman*
Butterfield	Johnson (IL)	*Ruppersberger*
Buyer	*Johnson, E. B.*	*Rush*
Calvert	Johnson, Sam	*Ryan (OH)*
Camp	Jones (NC)	Ryun (KS)
Cannon	*Jones (OH)*	*Sabo*
Cantor	*Kanjorski*	*Salazar*
Capito	*Kaptur*	*Sánchez, Linda T.*
Capps	Keller	*Sanchez, Loretta*
Capuano	Kelly	<u>Sanders</u>
Cardin	Kennedy (MN)	Saxton
Cardoza	*Kennedy (RI)*	*Schakowsky*
Carnahan	*Kildee*	*Schiff*
Carson	*Kilpatrick (MI)*	Schmidt
Carter	*Kind*	*Schwartz (PA)*
Case	King (NY)	Schwarz (MI)
Castle	Kirk	*Scott (GA)*
Chabot	Kline	*Scott (VA)*
Chandler	Knollenberg	Sensenbrenner
Clay	Kolbe	*Serrano*
Cleaver	*Kucinich*	Sessions

Clyburn
Coble
Cole (OK)
Conaway
Conyers
Costa
Costello
Cramer
Crenshaw
Crowley
Cubin
Cuellar
Culberson
Cummings
Cunningham
Davis (AL)
Davis (CA)
Davis (FL)
Davis (IL)
Davis (KY)
Davis (TN)
Davis, Jo Ann
Davis, Tom
Deal (GA)
DeFazio
DeGette
Delahunt
DeLauro
DeLay
Dent
Doggett
Doolittle
Doyle
Drake
Dreier
Edwards
Emerson
Engel
English (PA)
Eshoo
Etheridge
Evans
Everett
Farr
Fattah
Feeney
Ferguson
Filner
Fitzpatrick (PA)
Forbes

Kuhl (NY)
LaHood
Langevin
Lantos
Larsen (WA)
Larson (CT)
LaTourette
Lee
Levin
Lewis (CA)
Lewis (GA)
Lewis (KY)
Linder
Lipinski
LoBiondo
Lofgren, Zoe
Lowey
Lucas
Lynch
Mack
Maloney
Manzullo
Marchant
Marshall
Matheson
Matsui
McCarthy
McCaul (TX)
McCollum (MN)
McCotter
McCrery
McDermott
McGovern
McHenry
McHugh
McIntyre
McKeon
McKinney
McMorris
McNulty
Meehan
Meeks (NY)
Melancon
Menendez
Mica
Michaud
Millender-McDonald
Miller (FL)
Miller (MI)
Miller (NC)

Sherman
Sherwood
Shimkus
Shuster
Simmons
Simpson
Skelton
Slaughter
Smith (NJ)
Smith (TX)
Smith (WA)
Snyder
Sodrel
Solis
Souder
Spratt
Stark
Stearns
Strickland
Stupak
Sullivan
Sweeney
Tancredo
Tanner
Tauscher
Terry
Thomas
Thompson (CA)
Thompson (MS)
Thornberry
Tiahrt
Tiberi
Tierney
Towns
Turner
Udall (CO)
Udall (NM)
Upton
Van Hollen
Velázquez
Visclosky
Walden (OR)
Walsh
Wasserman Schultz
Waters
Watson
Watt
Waxman
Weiner
Weldon (FL)

Ford	Miller, Gary	Weldon (PA)
Fortenberry	*Miller, George*	Weller
Fossella	*Mollohan*	Westmoreland
Foxx	*Moore (KS)*	Wicker
Frank (MA)	*Moore (WI)*	Wilson (NM)
Frelinghuysen	Moran (KS)	Wilson (SC)
Gallegly	Murphy	Wolf
Gerlach	*Murtha*	*Woolsey*
Gibbons	Myrick	*Wu*
Gingrey	*Nadler*	Young (AK)
Gohmert	*Napolitano*	Young (FL)

---- NOT VOTING 19 ---

Berman	Foley	Ros-Lehtinen
Bishop (GA)	*Markey*	*Roybal-Allard*
Boswell	*Meek (FL)*	Shaw
Brown-Waite, Ginny	*Moran (VA)*	*Wexler*
Diaz-Balart, L.	Platts	Whitfield
Diaz-Balart, M.	*Reyes*	
Emanuel	Reynolds	

FINAL VOTE RESULTS FOR ROLL CALL 545

(Republicans in roman; Democrats in *italic*; Independents underlined)

H R 1461 RECORDED VOTE 26-Oct-2005 4:49 PM
AUTHOR(S): Garrett of New Jersey Amendment
QUESTION: On Agreeing to the Amendment

	AYES	NOES	PRES	NV
REPUBLICAN	53	168		9
DEMOCRATIC	4	189		9
INDEPENDENT		1		
TOTALS	**57**	**358**		**18**

---- AYES 57 ---

Akin	Flake	Paul
Alexander	Franks (AZ)	Pence
Baker	Garrett (NJ)	Petri
Barrett (SC)	Gohmert	Pitts
Bartlett (MD)	Green (WI)	Platts
Barton (TX)	Gutknecht	Putnam
Blackburn	Harris	Radanovich
Boustany	Hensarling	Royce
Burgess	Hostettler	*Rush*
Carter	Istook	Ryan (WI)
Castle	Jindal	Sensenbrenner
Chocola	Jones (NC)	Shadegg
Cooper	King (IA)	Sodrel
Culberson	Kolbe	Stearns
Davis, Jo Ann	Leach	Tancredo
Deal (GA)	McCrery	*Taylor (MS)*
Delahunt	Musgrave	Tiahrt
Duncan	Nussle	Weldon (FL)
English (PA)	Otter	Westmoreland

---- NOES 358 ---

Abercrombie	Graves	Neugebauer
Ackerman	*Green, Al*	Ney
Aderholt	*Green, Gene*	Northup
Allen	*Grijalva*	Norwood
Andrews	*Gutierrez*	Nunes

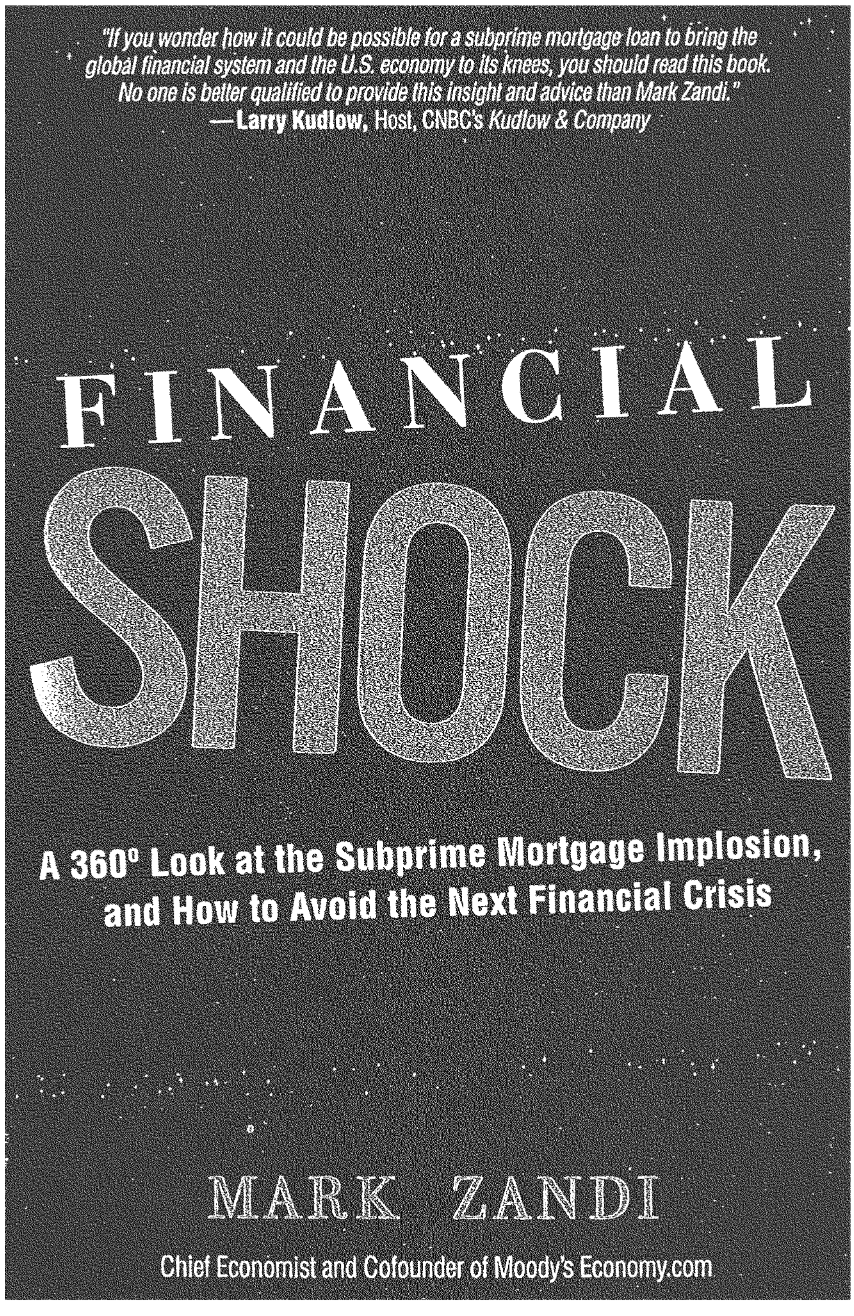
Baca	Hall	*Oberstar*
Bachus	*Harman*	*Obey*
Baird	Hart	*Olver*
Baldwin	*Hastings (FL)*	*Ortiz*
Barrow	Hastings (WA)	Osborne
Bass	Hayes	*Owens*
Bean	Hayworth	Oxley
Beauprez	Hefley	*Pallone*
Becerra	Herger	*Pascrell*
Berkley	*Herseth*	*Pastor*
Berman	*Higgins*	*Payne*
Berry	*Hinchey*	Pearce
Biggert	*Hinojosa*	*Peterson (MN)*
Bilirakis	Hobson	Peterson (PA)
Bishop (NY)	Hoekstra	Pickering
Blumenauer	*Holden*	Poe
Blunt	*Holt*	Pombo
Boehlert	*Honda*	*Pomeroy*
Boehner	*Hooley*	Porter
Bonilla	*Hoyer*	Price (GA)
Bonner	Hulshof	*Price (NC)*
Bono	Hunter	Pryce (OH)
Boozman	Hyde	*Rahall*
Boren	Inglis (SC)	Ramstad
Boucher	*Inslee*	*Rangel*
Boyd	*Israel*	Regula
Bradley (NH)	Issa	Rehberg
Brady (PA)	*Jackson (IL)*	Reichert
Brady (TX)	*Jackson-Lee (TX)*	Renzi
Brown (OH)	*Jefferson*	Reynolds
Brown (SC)	Jenkins	Rogers (AL)
Brown, Corrine	Johnson (CT)	Rogers (KY)
Burton (IN)	Johnson (IL)	Rogers (MI)
Butterfield	*Johnson, E. B.*	Rohrabacher
Buyer	*Jones (OH)*	*Ross*
Calvert	*Kanjorski*	*Rothman*
Camp	*Kaptur*	*Ruppersberger*
Cannon	Keller	*Ryan (OH)*
Cantor	Kelly	Ryun (KS)
Capito	Kennedy (MN)	*Sabo*
Capps	*Kennedy (RI)*	*Salazar*
Capuano	*Kildee*	*Sánchez, Linda T.*
Cardin	*Kilpatrick (MI)*	*Sanchez, Loretta*
Cardoza	*Kind*	Sanders
Carnahan	King (NY)	Saxton
Carson	Kingston	*Schakowsky*
Case	Kirk	*Schiff*
Chabot	Kline	Schmidt

Chandler	Knollenberg	*Schwartz (PA)*
Clay	*Kucinich*	Schwarz (MI)
Cleaver	Kuhl (NY)	*Scott (GA)*
Clyburn	LaHood	*Scott (VA)*
Coble	*Langevin*	*Serrano*
Cole (OK)	*Lantos*	Sessions
Conaway	*Larsen (WA)*	Shays
Conyers	*Larson (CT)*	*Sherman*
Costa	Latham	Sherwood
Costello	LaTourette	Shimkus
Cramer	*Lee*	Shuster
Crenshaw	*Levin*	Simmons
Crowley	Lewis (CA)	Simpson
Cubin	*Lewis (GA)*	*Skelton*
Cuellar	Lewis (KY)	*Slaughter*
Cummings	Linder	Smith (NJ)
Cunningham	*Lipinski*	Smith (TX)
Davis (AL)	LoBiondo	*Smith (WA)*
Davis (CA)	*Lofgren, Zoe*	*Snyder*
Davis (IL)	*Lowey*	*Solis*
Davis (KY)	Lucas	Souder
Davis (TN)	Lungren, Daniel E.	*Spratt*
Davis, Tom	*Lynch*	*Stark*
DeFazio	Mack	*Strickland*
DeGette	*Maloney*	*Stupak*
DeLauro	Manzullo	Sullivan
DeLay	Marchant	Sweeney
Dent	*Markey*	*Tanner*
Dicks	*Matheson*	*Tauscher*
Dingell	*Matsui*	Taylor (NC)
Doggett	*McCarthy*	Terry
Doolittle	McCaul (TX)	Thomas
Doyle	*McCollum (MN)*	*Thompson (CA)*
Drake	McCotter	*Thompson (MS)*
Dreier	*McDermott*	Thornberry
Edwards	*McGovern*	Tiberi
Ehlers	McHenry	*Tierney*
Emerson	McHugh	*Towns*
Engel	*McIntyre*	Turner
Eshoo	McKeon	*Udall (CO)*
Etheridge	*McKinney*	*Udall (NM)*
Evans	McMorris	Upton
Everett	*McNulty*	*Van Hollen*
Farr	*Meehan*	*Velázquez*
Fattah	*Meek (FL)*	*Visclosky*
Feeney	*Meeks (NY)*	Walden (OR)
Ferguson	*Melancon*	Walsh
Filner	*Menendez*	Wamp

Fitzpatrick (PA)	Mica	*Wasserman Schultz*
Forbes	*Michaud*	*Waters*
Ford	*Millender-McDonald*	*Watson*
Fortenberry	Miller (FL)	*Watt*
Fossella	Miller (MI)	*Waxman*
Foxx	*Miller (NC)*	*Weiner*
Frank (MA)	Miller, Gary	Weldon (PA)
Frelinghuysen	*Miller, George*	Weller
Gallegly	*Mollohan*	Wicker
Gerlach	*Moore (KS)*	Wilson (NM)
Gibbons	*Moore (WI)*	Wilson (SC)
Gilchrest	Moran (KS)	Wolf
Gillmor	*Moran (VA)*	*Woolsey*
Gingrey	Murphy	*Wu*
Gonzalez	*Murtha*	*Wynn*
Goode	Myrick	Young (AK)
Goodlatte	*Nadler*	Young (FL)
Gordon	*Napolitano*	
Granger	*Neal (MA)*	

---- NOT VOTING 18 ---

Bishop (GA)	Diaz-Balart, M.	*Reyes*
Bishop (UT)	*Emanuel*	Ros-Lehtinen
Boswell	Foley	*Roybal-Allard*
Brown-Waite, Ginny	Johnson, Sam	Shaw
Davis (FL)	*Marshall*	*Wexler*
Diaz-Balart, L.	*Pelosi*	Whitfield


"If you wonder how it could be possible for a subprime mortgage loan to bring the global financial system and the U.S. economy to its knees, you should read this book. No one is better qualified to provide this insight and advice than Mark Zandi."
—Larry Kudlow, Host, CNBC's Kudlow & Company
FINANCIAL
SHOCK
A 360° Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis
MARK ZANDI
Chief Economist and Cofounder of Moody's Economy.com

President Bush readily took up the homeownership baton at the start of his administration in 2001. Owning a home became one pillar of his "ownership society," a vision in which everyone would possess a stake in the American economy. For millions, this meant owning their own home. In summer 2002, Bush challenged lenders to add 5.5 million new minority homeowners by the end of the decade; in 2003 he signed the American Dream Downpayment Act, a program offering money to lower income households to help with down payments and closing costs on a first home. Lenders gladly accepted Bush's challenge.

To reinforce this effort, the Bush administration put substantial pressure on Fannie Mae and Freddie Mac to increase their funding of mortgage loans to lower-income groups. Both Fannie and Freddie had been shown to have substantial problems during the corporate accounting scandals in the early 2000s, and both were willing to go along with any request from the administration. OFHEO set aggressive goals for the two giant institutions, which they met in part by purchasing subprime mortgage securities. By the time of the subprime financial shock, both had become sizable buyers of the Aaa tranches of these securities.

Democrats in Congress were worried about increasing evidence of predatory lending. Some noted that the 2001 rule prohibiting such lending only applied to federally regulated lenders. North Carolina had passed a law banning predatory practices in 1999, and the Democrats wanted a federal equivalent that would cover all lenders nationwide. The Bush administration and most Republicans in Congress were opposed, believing legislation would overly restrict lending and thus slow the march of home ownership; moreover, the Republicans argued, existing regulations were adequate to discourage the worst excesses. The last attempt to pass anti-predatory lending legislation occurred in 2005, but it was also stymied. It was thus up to regulators to strike the appropriate balance between promoting home ownership and ensuring prudent lending. All too obviously, they failed to strike that balance.

regulatory domain of the Federal Reserve. The Basel II rules on banks' capital reserve requirements were being fashioned at about the same time. These rules rely heavily on market forces; how much capital banks need, and therefore how aggressive they can be in their lending, is determined mainly by the market value of their holdings. The fashion in banking circles was to let the market—not old-fashioned regulators—determine what was appropriate.

There was some notable dissent on this from within the Federal Reserve itself. Fed governor Edward Gramlich, a well-respected former economics professor from the University of Michigan, was notably vocal early in the lending boom. Gramlich, who was responsible for consumer affairs at the Fed, felt the central bank should take the lead in weeding out predatory lending by examining both the federally regulated banks under the Fed's auspices and their mortgage affiliates, which were not.[11] These proposals went nowhere. Chairman Greenspan argued that Gramlich's proposed examinations would not have stopped shady lending, and that they might inadvertently bestow on shady lenders the ability to claim the Fed's seal of approval.[12]

At various times, Congress also exhorted the Fed to address nagging concerns about excesses in the mortgage market. In 1994, the House and Senate passed the Home Ownership and Equity Protection Act (HOEPA), which authorized the Fed to prohibit unfair or deceptive mortgage lending.[13] Under the HOEPA, the Fed has the authority to prohibit predatory lending practices by any lender, no matter who regulates it. The Fed used these powers only sparingly, arguing against the need for blanket rules on unfairness or deception. Each case is different, Fed officials claimed.

Almost a decade later, Congressional Democrats pushed the Fed to use its authority under the Federal Trade Act to write rules on unfair and deceptive lending practices. Again, it was to no avail. Greenspan tossed the ball back to Congress, saying the legislature was better suited to define the practices it wanted to bar and make whatever laws were necessary. In other words, if there was improper lending going on, Congress would have to deal with it—not the Fed, and not, by extension, the nation's bank regulators.

Don't Worry, Be Happy

Although Greenspan ultimately acknowledged that he had erred in thinking that the market would discipline lenders, his doubts about banking regulation were not without merit. Among other problems, it is hard for regulators to avoid getting caught up in the same euphoria that envelops lenders during good times. Instead of restraining overly aggressive lenders in such periods, regulators may encourage them.

The housing boom period illustrates the point. Mortgage credit conditions couldn't have seemed better in those years. By 2005, with unemployment declining and house prices surging, delinquencies and defaults had dropped to record lows. Hardly a borrower in San Diego or Miami was even late with a payment. Regulators would have had great difficulty making the case to lenders that their lending standards were out of whack: the regulators had no tangible evidence to point to, even if they had wanted some.

Regulators also could not keep up with the explosion of new and increasingly complex mortgage loans. Although interest-only, negative-amortization, and subprime loans had been around in some form for years, they had never been offered so widely to all kinds of borrowers in parts of the country where they had never before been available. Regulators didn't have time to evaluate all the new arrangements, let alone determine whether they were appropriate or what to do if they were not.

State regulators were particularly ill-equipped to confront lenders, especially in those states where housing was at its frothiest. Many state agencies were completely outmanned. At the peak of California's housing boom, for example, no more than 30 state examiners watched over nearly 5,000 consumer finance companies, including some of the nation's most aggressive mortgage lenders.[14] The