EXPERTS' PERSPECTIVES ON SYSTEMIC RISK AND RESOLUTION ISSUES

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

SEPTEMBER 24, 2009

Printed for the use of the Committee on Financial Services

Serial No. 111–78

U.S. GOVERNMENT PRINTING OFFICE

54–869 PDF WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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EXPERTS' PERSPECTIVES ON SYSTEMIC RISK AND RESOLUTION ISSUES

Thursday, September 24, 2009

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

The committee met, pursuant to notice, at 9:05 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Watt, Sherman, Meeks, Moore of Kansas, McCarthy of New York, Baca, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Bean, Klein, Wilson, Perlmutter, Foster, Carson, Minnick, Adler, Driehaus, Kosmas, Himes, Maffei; Bachus, Castle, Royce, Lucas, Manzullo, Jones, Biggert, Capito, Hensarling, Neugebauer, Price, Posey, Jenkins, Lee, Paulsen, and Lance.

The CHAIRMAN. This hearing of the Committee on Financial Services will come to order.

We will be having this hearing today and one tomorrow—well, actually, this is the last of the general hearings that we will be having on this subject. Tomorrow, we will begin legislative hearings because we will have a hearing tomorrow on the legislation submitted by our colleague, Mr. Paul of Texas, which is a piece of legislation dealing with auditing of the Federal Reserve.

And we are concluding today, and one topic that has been a very significant concern is that there is universal dislike of the doctrine of "too-big-to-fail" and even more, the practice of "too-big-to-fail." Unfortunately, there does not appear to be a single, simple solution to it. Passing a statute that says nobody is "too-big-to-fail" doesn't resolve the problem.

One of our major goals in drafting legislation has been to come up with a series of measures that will avoid our facing that situation of "too-big-to-fail." We will try to keep institutions from being so overleveraged that they are likely to fail. We will try to prevent imprudent decisions, for instance, that come from 100 percent securitization that come from derivatives that are overly leveraged without sufficient collateral. We will give some collection of Federal agencies the authority to step in when it appears that institutions or patterns of activity are being systemically threatening and order containment of these activities; and we will have, what I guess I am destined to have to continue to refer to as the "resolution authority" which, in English, is the "dissolution authority," the ability of regulators to step in and put an institution to death without the kind of tremors that occurred or will occur today.

Now there does appear to be broad agreement, I think, in the committee on all sides about those goals. How we do them we will differ about. But it was clear yesterday that no one thinks that the current choice of straight bankruptcy or nothing is workable for the institutions. We have to come up with a method of resolving. We have done that, and we shouldn't deny ourselves the regular sum successes. Where insured depository institutions are involved, we have a system that works pretty well.

Wachovia is a pretty big institution. It failed. This didn't cause systemic disruption. It wasn't good for the people who were there.

Other insured depository institutions have failed, and we have been able to deal with that. We need to extend that.

On the other hand, non-depository institutions, Bear Stearns, Merrill Lynch, AIG, and Lehman Brothers all failed, and all were dealt with—each of these was dealt with in a different way and none were satisfactory to anybody, as nearly as I can see. A forced takeover of Merrill Lynch by Bank of America, the negative consequences of that are still reverberating.

Paying nobody in the case of Lehman Brothers, none of the creditors, and causing, according to the Administration officials at the time, a terrible shock to the system; paying everybody in AIG, which no one, except the people who got paid, thinks was a good idea now.

And Bear Stearns, which was the smallest of them and actually was probably handled in the least disruptive way but still because it was that hot caused some problems.

So one of the things we expect people to address today, I hope they will address today, is what combination of measures we can take to get rid of the doctrine of "too-big-to-fail."

There was one proposal that came from some within the Administration that we would have a list of the institutions that would be considered "too-big-to-fail," a list of the systemically important institutions so that we could deal with them, but the general view was that would be considered to be the list of those "too-big-to-fail," and what the Administration thought would be a scarlet letter, would instead be a license to have people invest with you because they would think they were protected.

So as I said, it is a high priority for this committee to deal with that and to have as nearly as it is humanly possible, a banishment from people's minds.

I will say this. I am resigned to the fact that cultural lag is one of the great constraints on what we do. And I accept the fact that until we reach the point where a large institution is put to death without there being "pay everybody" or other inappropriate compensations, people won't believe us. We can arm the regulators to do this, we can arm people to do it, and I accept the fact that not until it is done will people believe it.

But I will say this: When people are skeptical, listen to the members of this committee and our colleagues. We will give the regulators the power to step in and make it clear that no one is "too-big-to-fail," that failure will eventuate, that it will be painful for those involved. There will be no moral hazard, no temptation to get that big. Any regulator who failed to use that power in the foresee-

able future will, I think, feel a uniform wrath from this place. So I would hope that people would be a little less skeptical.

We are not going away. The country's anger about this isn't going away. So we aren't just setting up the tools; we are arming ourselves in a way that I think will be very effective.

The gentleman from Alabama is now recognized for 5 minutes.

Mr. BACHUS. I thank the chairman, and I agree with him that the problem of "too-big-to-fail" is one of the most pressing and contentious issues of the regulatory reform and debate. And how that is resolved I think will go a long way to moving regulatory reform ahead.

Chairman Volcker, we know you as a gentleman and also someone whose opinion we respect very much. So we welcome you to this committee hearing. And I know you share some of the same concerns that the chairman shares and that I share and that most of our colleagues share.

The chairman yesterday in the hearing with Treasury Secretary Geithner identified the "too-big-to-fail" problem as the one that most aggravates people in this country. And I agree with you, Chairman Frank, it not only aggravates them, it outrages them on many occasions.

The American taxpayers are tired of paying for Wall Street's mistakes, our guaranteeing their obligations. They see something manifestly and something wrong with a casino environment in which high rollers pocket the profits, often measured in millions, if not billions, of dollars while the taxpayers pay off the losses.

The American people are justifiably outraged by a "heads I win, tails you lose" approach. When we designate 10 or 20 of our largest financial institutions as "too-big-to-fail," we endorse a financial marketplace in which a handful of enormous financial institutions are supported by the promise of government-engineered, taxpayer-funded bailouts.

We also pull people in, assuming they will be saved and assuming there is a guarantee.

The time has come for every member of this body to reject once and for all the concept of taxpayer bailouts of these so-called "too-big-to-fail" institutions. Equally important is the fact that in concept and in practice, "too-big-to-fail" necessarily creates a much larger universe of companies and businesses which are deemed unworthy and too small to save. To establish, as law, such a disparate, inequitable, and discriminatory treatment not only should offend our sense of fair play and justice, its elitist operation should be rejected out of hand as contrary to our democratic principles.

The Administration wants to codify a permanent bailout authority with its proposal to create a resolution authority. It really is a permanent TARP administered by government bureaucrats with even less accountability than was present in the current incarnation of TARP. The beneficiaries of the Administration's plan are not the American people or the vast majority of small- and medium-sized companies and businesses that choose not to engage in the kind of risky financial activity that led to the financial market collapse. The more responsible individuals of the institutions and inevitably the taxpayers will pay for the bailouts but they will not benefit.

Indeed, just yesterday, in testimony before this committee, Treasury Secretary Geithner declined repeated invitations to rule out future taxpayer-funded rescues of systemically significant firms. In response to my question about taking assistance to these firms off the table, Secretary Geithner compared such an action as abolishing the fire station, which I took to mean he would not agree to stop bailouts. And when asked repeatedly by Congressman Brad Sherman, if the Secretary would accept even a trillion dollar limit on bailout authority, Secretary Geithner said, "I would not."

In conclusion, by contrast, Republicans have offered a workable alternative to the bailout status quo. In addition to curtailing the Fed's authority to bail out individual firms, Republicans support enhanced bankruptcy for failed nonbank financial institutions similar to the authorities that the FDIC has for banks. By sending a clear, credible signal to the marketplace that failed nonbank financial firms will face bankruptcy and need to plan accordingly, and the people who do business with them, the Republican plan restores market discipline, mitigates moral hazard, and protects taxpayers.

Mr. Chairman, no institution should be "too-big-to-fail." Institutions can and should fail if their bad decisions render them insolvent and they cannot compete in the marketplace. To pretend otherwise is to weaken the foundation of our economic system.

The better question is, will we have the courage to do the right thing, and reject the Administration's effort to move us to a system of gigantic but weak banks kept on—well, that is it. And these are real questions.

I thank the chairman, and I also thank the former Chairman of the Fed for being with us today.

The CHAIRMAN. The gentleman from Georgia is recognized for 3 minutes.

Mr. SCOTT. Thank you, Mr. Chairman, and welcome, Mr. Volcker.

We are at a juncture in our dealing with this in terms of putting the regulatory reforms to—I think at the same time do a little check on our record going forward of how well what we have done and is it doing the job?

The American people are registering some great concerns. Poll after poll has indicated that there is a—while Wall Street and those at the top appear to be saying that this economy is changing, we are bottoming out. That is not so on Main Street because we have another set of parameters that are working there.

And I would like to get your opinions on—I have a great deal of respect for you and your history and your knowledge. But I think as we look at this issue, we need to be concerned about any variations of what we would refer to as a double dip recession.

There are people who are still expressing concerns over the economy and problems that will loom greater. I am particularly concerned, Mr. Volcker, about unemployment. The issue in our focus really needs to be on jobs now because if we don't get to the bottom of that we gradually begin to lose the faith of the American people. The issue needs to be on jobs, the issue needs to be on our banks. For some reason, with all of the money we have given them, with the bailouts we have given them, with many of them going back

to their ways of directing bonuses and huge salaries, there is a hypocritical nature that is setting in because at the same time, these banks are not lending. So if you are not lending, especially to small businesses, they are going out of business. They are the ones that created the jobs.

So I think as we go forward with our regulatory reforms we have to look at it with a very jaundiced eye and see as we put these regulatory reforms in place, what more can we do to prime the pump to get money flowing out into the communities.

The other area of great concern to me—and certainly to my folks down in Georgia—is a record number of bank closures. And as we look at these regulatory reforms, one size does not fit all. What is the future of those small community banks that basically do the lending, that are the foundations in many of our smaller communities? Those are the banks that are being closed left and right. We lead the Nation in Georgia in those bank closures, and a part of the reason is they can't get the capitalization.

So I think as we go forward I would be very interested to hear some of your concerns on giving us a scorecard, giving us a report card. We have been at this now for basically a year. This thing happened a year ago. We have been moving at it, and I think it is about time to get a little report, and I would be interested to hear your comments on that.

The CHAIRMAN. The gentleman from Delaware is recognized for 1½ minutes.

Mr. CASTLE. Thank you, Mr. Chairman. I actually do not have an opening statement. I don't know if the ranking member wanted to add to his time.

The CHAIRMAN. I was given a list by the minority. I wasn't trying to draft you.

Mr. CASTLE. I will yield back my time, maybe in the hopes of actually hearing a witness.

The CHAIRMAN. The other two listed aren't here. I have 2 minutes from Mr. Green, and we can proceed. The gentleman from Texas is recognized for 2 minutes.

Mr. GREEN. Thank you, Mr. Volcker, for being here.

Mr. Volcker, sir, you are a sage, and we welcome your attendance. I eagerly anticipate what you have to tell us. You have shepherded this country in some very difficult times, and I think you should be commended for your history of being there when your country needed you.

I want to concur with the ranking member when he talks of "too-big-to-fail" because quite candidly, I agree. "Too-big-to-fail" is the right size to regulate, but it is also the right size to prevent from becoming "too-big-to-fail," and it is the right size to put in a position such that we can wind it down without costing the taxpayers any dollars.

The idea is not to bail out "too-big-to-fail," it is to put those that may be "too-big-to-fail" in such a position that we can wind them down and not allow another AIG to prevail. That is what it is really all about.

We also want to do this. We don't want to put ourselves in a position where we are designating by way of a list. We want to regulate such that we don't have to designate. As a company, AIG

starts to become so large that it may fail, we want to start the regulatory process such that it won't get there, and if indeed it does by some accident, then we want to have a way to do what we do with banks in this country, and that is wind them down and not cost the taxpayers any dollars.

Finally, this: There is, I believe, a desire on this side to work with persons on the other side to accomplish this mission. I am willing to work with the ranking member and anyone else who would like to put us in a position such that we don't ever have to deal with another "too-big-to-fail," such that we will always have that safety net to protect the American economy.

Nobody was bailing out AIG. We bailed out the American economy, and in fact we were bailing out the economy on a global basis as well.

I thank you for your sage advice and look forward to hearing from you.

I thank you, Mr. Chairman

The CHAIRMAN. Mr. Volcker, we thank you for joining us. Mr. Volcker has a very long list of titles which, under the 5-minute rule, I could not finish reading even at my speed. But we are very pleased that he came up today, especially to share his experiences with us.

Please, Mr. Volcker.

STATEMENT OF THE HONORABLE PAUL A. VOLCKER, FORMER CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Thank you, Mr. Chairman, and members of the committee.

It has been a long time since I have been in the room. It is a familiar room, and I appreciate the opportunity because you are dealing with particularly important problems.

Let me just say in a preliminary way, as you know, the President has said—as Mr. Geithner has said, if the market betters, the economy steadying, there has been some feeling of relaxation about some of these issues and some feeling of maybe just return to business as usual, return to making money, outside amounts of money, certain resistance to change. And from the comments that you have made, I am sure you will not respond to that by slowing down, but rather proceeding with all deliberate speed to get this right. It is really important.

It is an incredibly complicated problem, and I want to concentrate on mainly the aspect that you have already emphasized. But before I do so, let me acknowledge that an awful lot of work is going on in various aspects by the regulatory agencies. They have taken important initiatives dealing with capital and liquidity, and they are working toward compensation practices.

And I would point out it is relevant with the G–20 meeting that a lot of what needs to be done really does require a certain consistency internationally because these markets are global and that just adds another complication. You can't have capital requirements, for instance, for American banks that are way out of line of capital requirements elsewhere, to take an easy example. But that is an additional complication.

But the central issue that I want to talk about really is what you have already said, moral hazard in financial markets. You know what that is all about. I don't have to explain it. But I would note that this is front and center because the active use of long-dormant emergency powers of the Federal Reserve together with extraordinary action by the Treasury and Congress to support non-bank institutions has extended this issue well beyond the world of commercial banking. "Too-big-to-fail" has been an issue in commercial banking; now it is an issue for finance generally.

I think it raises very important substantive questions. It raises some administrative questions that I want to touch upon, too. It raise legal questions. And one of those questions is the role of the Federal Reserve, which I will return to.

In dealing with that, I submitted a long statement which deals with all of this in more detail. Just to cut to the chase, you know, the Administration has set out a possible approach, which I feel somewhat resistant to or more than somewhat resistant because I think it does suffer from conceptual and practical difficulties.

Now what they suggested is setting out a group of particular institutions that, in their judgment, would pose a systemic risk in the event of failure.

I don't know what criteria would be used precisely in determining these institutions because the market changes, it is not always directly relevant to size. That in itself would be a great challenge. But I think it is fair to say that the great majority of systemically important institutions are today, and likely to be in the future, the mega-commercial banks. We are talking about in the center of things, the commercial banking problem. That is true here, that is true abroad, and in this case we already have an established safety net. The commercial banks that are at the heart of the problem are already subject to deposit insurance, central bank credit facilities, and other means of support.

I have a little hobby of asking friends and acquaintances when they talk to me with experience in financial markets, I say, Now, outside of commercial banks, outside of insurance companies, which I would say parenthetically I hope better regulatory systems will be developed, maybe not as part of this legislation but next year. Apart from commercial banks and insurance companies, how many genuinely systemically important institutions do you think there are in the whole world, financial markets. I will tell you the answer I get consistently is somewhere between 5 and 25. The universe is not huge when you are talking about non-banking, non-insurance company, systemically important institutions.

Now, if you extend this idea of developing a group of systemically important institutions for your own banks, then the moral hazards problem has obviously increased because the connotation is if they are systemically important, officially identified, they fall in the same category as banks, and the government better be especially alert to dealing with them in case of difficulty.

Now, it does seem to me a better approach would be to confine the safety net to where it is, that is to commercial banking organizations. And as part of that organization now and even more so in the future, the banking supervisors would, I think, as a natural

part of their responsibility, be especially attentive to the risks posed by the largest banking organizations.

So they ought to have the discipline to insist upon best practice among those organizations, not just in the United States but generally worldwide by agreement. We have to agree to more adequate capital, responsible cooperation with other supervisory concerns, and leave it as ambiguous as you can as to whether government assistance would ever be provided in these emergency situations.

Now that approach recognizes, I think, the reality that the commercial banks are the indispensable backbone of the financial system. Mr. Scott talked a bit about the importance of community banks, regional banks and credit. That is part of it. They also act as depository, they take care of the payment system, they offer investment advice, they maintain international financial flows. These are all essential services that justify a special sense of protection.

Now, when you get to what are called capital market activity, a lot of trading, hedge funds, private equity funds, a lot of other activity, credit default swaps,CDOs, CDO squared, all that stuff, it is a different business. It is an impersonal position. It is a trading business, and it is useful. We need strong capital markets, but they are not the same as customer-related commercial banking functions and they do have substantial risks. Banking itself is risky enough. You add capital market operations to that, you are just compounding the risk. And I would note it is—they present conflicts of interest for customer relationships.

When a bank is rendering advice and maybe investment advice to a company, it is rendering underwriting services and then it is turning around and creating in those same activities, does it bias the customer advice? Does it undercut the customer relationship? Is it consistent with the customer relationship? Those problems are enormously difficult, and I think demonstrably have been a big distraction for bank management and led to weaknesses in risk management practices.

So I would say the logic of this situation is to prohibit the banking organizations, and by “banking organizations,” I am talking about the bank and its holding company and all of the related operations. I would prohibit them from sponsoring or capitalizing hedge funds, private equity funds, and I would have particularly strict supervision enforced by capital and collateral requirements toward proprietary trading in securities and derivatives.

Now, how do you approach all of this and deal with the big nonbank that might get in trouble?

That I think is where this resolution authority comes into play. Can we have a system, knowledge as to what we have with banks, a government authority can take over a failed or failing institution, manage that institution, try to find a merger partner if that is reasonable, force the end of the equity if there is no equity really left in the company, ask debt holders, negotiate with debt holders to exchange dept for equity to make the company solvent again, if that is possible. If none of that is possible, arrange an orderly liquidation. And none of that necessarily involves the injection of government money and taxpayer money but it provides an organized procedure for letting down what I hope is a very rare occurrence of the failure of a systemically important nonbank institution.

Now who has all of this authority and how are the general regulatory and supervisory arrangements rejiggered, if at all, and I do think they do need some rejiggering. I would mention one aspect of that. The Treasury itself has correctly identified the need for what I call an overseer. Somebody, some organization that is responsible not just for individual institutions but responsible for surveying the whole financial system, identifying points of weakness, which may or may not lie in an individual institution. It may lie in new trading developments. But take two obvious examples.

Who was alert to the rise of the subprime mortgage a few years ago? It may not have appeared to have presented a risk at the time for an individual institution, but it sure in its speed of increase and its weakness presented a risk to the whole system. Somebody should have been alerted to that. Who has been looking at credit default swaps and wondering whether they reach the point of creating a threat to the system? And the answer is basically nobody and not very well. And somebody should have that responsibility.

The Treasury has been very eloquent on that point. They have suggested a kind of council or regulatory agency headed by the Treasury. I frankly don't think that is a very effective way to do it because getting a bunch of agencies together and getting to agreement on anything, and they all have their particular responsibilities, their particular constituencies are a very tough business. So if you do it that way you have to be a Treasury. You have to build up a new staff in the Treasury.

The alternative is the Federal Reserve. I spent a lot of time in the Treasury so I am not particularly prejudiced of the Federal Reserve, I would argue, but I think this is a natural function for the Federal Reserve. I think consciously or unconsciously we have looked to the Federal Reserve. Whether the responsibility has been discharged effectively or not, there is a sense that the Federal Reserve is the agency, the major agency to be concerned with the whole financial market, and there is no doubt when you get in trouble, when anybody in the financial markets gets in real trouble they run to the Federal Reserve.

The Federal Reserve has the authority, the money. It presumably has the experience and capabilities, and I think that simple fact ought to be recognized. It is a very important institution. It seems to be logical that they ought to be kind of assigned explicitly what I always thought they had implicitly, a kind of surveillance of a whole system.

[The prepared statement of Mr. Volcker can be found on page 93 of the appendix.]

The CHAIRMAN. Obviously, this has been very helpful on a broad range.

I want to talk about one issue that you care a lot about and in which your experience really gives you a great deal of authority. It hasn't gotten much attention, and that is the concern you have about the problems raised by proprietary trading within the banks, the bank holding companies. You have some fairly strong views about restricting that. You mentioned it, but I would ask you to elaborate on that because I think that is, as I look at it, is one of the important topics. It hasn't gotten discussed much. I know it

was raised by some others, there is Mr. Levitt, Ms. Donaldson who had that in their—I think in their investors' list of concerns.

So is it feasible to just ban it, or how would you deal with the question of proprietary trading by the institutions?

Mr. VOLCKER. When I comment that I think banks should be restricted in their, what I think of as truly capital market impersonal activity, it is pretty easy to talk about hedge funds and equity funds because they are identifiable institutions. Proprietary trading is not an identifiable institution in the same way, although many financial institutions will have a proprietary trading desk. That is the way they label it themselves.

The CHAIRMAN. That is the way they have labeled it, before you get through. That is the way it has traditionally been labeled by some, but by the time you are through testifying, they will probably have a new name for it.

Mr. VOLCKER. However it is labeled, I think conceptually there is a difference and can't be denied that a company, a bank, or whatever it is, is trading actively in the market, the securities that bear no customer relationship, no continuing interest. They are interested in making a profit on a particular trade or making a speculative profit. And that activity, in some institutions anyway, has become increasingly important and it is inherently risky, it inherently presents a conflict of interest. It inherently is hard to manage. Some people are good at it, some people are not so good at it. It takes a lot of concentration.

How do you deal with it because there is some perfectly legitimate trading that goes on in a bank or financial institution, and it is an outgrowth of their customer interest. If they are underwriting securities and lending securities for a particular customer, they may want to trade in those securities that they have underwritten, to take a simple example. And if they are going to do some trading, they have to maintain a certain liquidity, a certain staff that is able do that. How do you distinguish between a kind of routine, low-level trading activity and proprietary trading as an active part of the money making business of the firm?

It is partly a matter of judgment and partly a matter of volume, but I think what you have to rely upon is supervisory discretion. You tell the supervisor that part of the concern of banking regulation should be cutting down on this kind of speculative activity, trading activity. And the supervisor certainly has the authority to arrange capital requirements that could be increasingly severe as the trading activity increased, and they could take other supervisory steps to assure that trading activity is in reasonable alignment with the customer orientation of the banks.

The CHAIRMAN. Thank you. So in essence, this is something that could be handled by underlining the supervisory authority, not by some kind of statutory bar but in the statute make it very explicit the grants of authority.

Mr. VOLCKER. I don't think you can write a bright line law to say what is proprietary and what isn't.

The CHAIRMAN. Just to be clear, because in the legislation we have been contemplating, that is already clearly identified as one of the tools that could be used in an institution which is being treated as a systemic risk. But your point is that it ought to be a

generic authority and that it is not a matter of the systemic risk but is a conflict in other ways.

On the question of the death panels, which is otherwise called the resolving authority—"death panel" has such a wonderful ring to it. Just because it is entirely inaccurate in one area, it doesn't mean it should pass from the debate. I think we ought to—we will save the phrase and use it where it makes some sense, and that is the resolving authority.

On the question about whether or not they should—I am out of time. So let me pose the question and you can elaborate on it.

There is obviously a big debate about whether or not public funds ought ever to be available in resolving the mess left behind by one of these institutions. If you could answer it briefly now and elaborate in writing, I would appreciate that.

Mr. VOLCKER. In terms of the resolution authority, which would give extraordinary authority to whatever agency is designated to control the institution, I do not think it is desirable to provide in that same arrangement authority to lend money or to provide money because that will encourage the "too-big-to-fail" kind of syndrome.

So if you give it strong enough authority to control the institution and to manage such things as forcing, negotiating or forcing, whatever word you want use, let us say a conversion of debt into equity, hopefully you would avoid the need for injecting money and the stockholder would lose, the creditor might lose, and the creditor should be concerned about whether he is going to lose.

Now, I would also say—I guess I didn't mention in this preliminary statement—that if the overseer, for instance, identified an institution or several institutions as being so large and so extended as to present a real risk, there would be some residual authority to place capital requirements on that institution, leverage requirements, maybe liquidity requirements. But that doesn't involve government money.

The CHAIRMAN. I appreciate it.

The gentleman from Alabama.

Mr. BACHUS. I thank the chairman.

Chairman Volcker, Secretary Geithner declined to rule out any more government bailouts of troubled institutions. And I think what we usually assume by that, we are not talking about the FDIC's traditional power to resolve depository institutions. He declined to do so.

Do you think that is a mistake?

Mr. VOLCKER. I would answer that question this way: I think you have the emergency power of the Federal Reserve, section 133. I am not proposing that be abolished. I have mixed feelings about that because I squirm when it is used, frankly. We spent a lot of time trying to avoid its use because we knew if it ever got used it would become a precedent for the future, and if we used it for New York, people will say we should use it for Chicago or the State of California. And we didn't use it for Chrysler 20 years ago, whenever it was. Well, demands arose because we didn't want to set the precedent of using it.

Well, our precedent has been set now in very strange circumstances, very radical circumstances. So understandably, it has been set.

But I think we want to develop attitudes and policies that say this is extremely extraordinary. It is part of the apparatus of the bank safety net, although it could be extended beyond that. I don't think I would promote that, but I wouldn't take it away.

Mr. BACHUS. We have sort of scrambled the egg. We have the commercial banks and the investment banks. Last September, some of the investment banks came under the safety net—

Mr. VOLCKER. Right.

Mr. BACHUS. —I think you have indicated, and I think many of us realize there is a difference in what was a commercial bank, a lending facility, and an investment or trading bank. In fact, if you look at the two investment banks, the two largest ones, their last report showed substantial profits from trading, which indicates a trade that they are still basically—their profits are being derived from trading derivatives and some of the things that you described.

Do we go back to that system?

Mr. VOLCKER. Well, we can have investment banks again. I guess there is only one big investment—well, two, one very active in trading, the other less active in trading. But I don't want those investment banks brought under the general safety net. There ought to be a distinction. And if they want to go out and do a lot of trading and that is a legitimate function, if they want to do whatever they want to do in the financial world, okay, but don't bring them under the safety net.

Mr. BACHUS. And if they fail, they go into an enhanced—

Mr. VOLCKER. If they fail, you use the resolution that is already as necessary.

Mr. BACHUS. Let me ask you another question, and I really have two.

One is I just want to acknowledge something and see—we did have—some of our failures were a result of the derivative trading and instruments that didn't exist 20 years ago. And you have talked about that.

You had another problem and that is depository institutions that went out and bought subprime affiliates that were not regulated at all. And I think that was a tremendous threat to the system.

Mr. VOLCKER. Absolutely.

Mr. BACHUS. Would you comment on that? You could go down the list of banks.

Mr. VOLCKER. The subprime phenomena is interesting because, you know, I am not in the middle of the markets these days, and I wasn't conscious of the speed in which they were increasing. They were a phenomena of practically a standing start to a trillion, trillion and a half dollar business in the space of 3 or 4 years that arose very rapidly, and apparently there was no clear sense in the regulatory community of the potential threat that this posed; and it probably, because they were obscured by the same thing that obscured bank managements and others, that we had some fancy financial engineering here that somehow presto magic, the risks go away if we put it in a big package and get a good credit rating, which is what they were getting.

But I think that was a failure in risk management, a failure of the credit rating agencies, but it also was a failure of the regulators that weren't on top of this. And this arose not in the traditional banks. They may have participated, and they did participate in the end, but it arose in kind of fringe operations, but nobody sat there and said look, this is a potential threat if it increases at this rate of speed to the financial system. Nobody that I know of. Somebody should have been raising that question.

And in my view, you know, as the Federal Reserve was already given clearance to do it, they are in the best position to do it.

Mr. BACHUS. There were loans that banks couldn't make. They wouldn't make it under their own underwriting standards. They wouldn't originate them in the banks so they went out and bought an unregulated subprime lender to make loans that they would never make.

The CHAIRMAN. The Federal Reserve was given that authority in 1994 because that is exactly the authority that Mr. Bernanke invoked in 2007 when he did finally promulgate rules, but that was unchanged from the authority that existed from 1994.

The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman.

Chairman Volcker, thank you for being here. I have been on this committee now for 17 years and there seem to be two acknowledged gurus in the financial services industry. Alan Greenspan was one. When he spoke, I never understood a darn thing that he ever said but he seemed very eloquent in his positions. And you are the second one, and I have heard you speak 3 times now.

I understand, I think, what you are saying, but it seems to me that your testimony this morning and the other times that I have heard you address the systemic risk issue leads us back exactly to where we are right now.

If we didn't do anything on systemic risk, we already have regulation of—we have all of the banks who are currently under regulations, and I am just trying to understand how—what you are proposing with respect to systemic risk differs from what we have now. That is the one question.

And I am going to put both of them out there and then I will shut up and listen to you talk.

The second question is, you have done a lot of work. I have read your report on the international monetary situation, and you led a group or participated in an international group that looked at this from an international perspective. And I didn't hear you address any of that this morning. I know we are here to deal with our domestic situation, but how do you see this being intertwined in the systemic issue being addressed on a worldwide basis unless we address it somehow more aggressively than you have proposed on the domestic side?

Mr. VOLCKER. Two relevant questions.

On the first question, I am not recommending anything particularly different so far as banks are concerned that already have lender of last resort, they already have deposit insurance, and we have some history of intervening with Federal Reserve money or government money in the case of failure of very large banking institutions. So that I take is a given. And that is common around

the world. There isn't a developed country that doesn't have a similar system to protect banks because banks are, I think, the backbone of the system.

Now it is also true in the United States the relevant importance of banks has declined in terms of giving credit because more of the credit creation has been going into securities, which is the province of the capital market.

What is different is the situation has changed where some of the benefits anyway, the safety net, has been extended outside the banking system. That is what I want to change.

But you can't change it just by saying it is not going to happen because you are going to have problems. You have to develop some other possibilities and arrangements to minimize the chances of a crisis. So that is what we are proposing.

Mr. WATT. So basically what you are proposing is taking some of the people who are now covered under the FDIC, have some kind of implicit backing and separating them out and making it clear that they don't have any kind of implicit backing. They are just going to be allowed to fail.

But I don't understand how that squares with your position that you retain, that the Fed retain emergency authority. Why wouldn't they still then in emergency situations continue, now that the precedent has been set, to use that emergency authority rather than whatever implicit authority?

Mr. VOLCKER. That is a legitimate question. Do you want to take the emergency authority away from the Federal Reserve and give it to nobody? I am not quite that radical at this point, given what we have been through. But it is a reasonable question. You are quite right, what I am trying to do is diminish the sense that it is there and available for nonbanks.

Now on the international side, if what you say is true, I deal a little bit with it in my long statement I have issued to the committee. And there are some issues where international cooperation will be clearly necessary and, in fact, it has a pretty good history so far and that is in the area of capital requirements.

There already is a high degree of uniformity in capital requirements. They are going to have to be reviewed, they are being reviewed nationally, they are being reviewed here and they are being reviewed in the U.K., but there is a body at the BIS, separate from the BIS, but a joint body of regulatory authorities to consider that issue. And they also have now extended their authority, encouraged by heads of state, to consider other matters of banking supervision and regulation where international consistency is important. And there are quite a few of those areas, and they have done quite a lot in trying to regularize practice. It is a big challenge, but it is important.

On some of these other things, it is equally important. I think you already have a framework where practically all big banks or big countries with relevant banking systems already have a safety net. That is different in detail but it is a common factor.

Now we have to deal with how all of these countries deal with their nonbanks. And I think some consistency there is important.

The other really big financial center, as you well know, is London. And these matters are under intense consideration by the reg-

ulatory authorities in London. And at the end of the day, I think it is important that there be some consistency between what we do here and what they do in the U.K., just as a start. And I think that is quite possible. It won't be perfect, but that is the way we started actually with capital requirements. We got an agreement between the U.K. and the United States, and then it got extended around the world. So maybe we can duplicate that.

The CHAIRMAN. Now I am going to try again. The gentleman from Delaware.

Mr. CASTLE. Thank you, Mr. Chairman.

Mr. Volcker, like probably everybody else on this committee, I have a tremendous amount of respect for your comments on the economy and this particular problem of banking in general. I want to thank you for being here. I have some questions concerning the Federal Reserve itself.

Let me throw a couple of things out and you can respond to them.

As we all know, the Federal Reserve has great responsibilities in the economy today—you know that better than any of us—all the way from monetary policy to interest rates, the emergency powers that you have discussed here today, and consumer protection.

The consumer protection may, in accord with whatever we do here in Congress, change and go over to be handled otherwise. But other than that, the remaining powers would be there.

You have suggested strongly that it is the best agency. You have suggested in your writing—I am not sure if you spoke it or not—appointing someone else who would have this responsibility confirmed by the Senate, etc., with respect to the systemic risk, etc., and I understand that.

But my question is, is the Federal Reserve taking on too much responsibility with respect to the monetary circumstances of this country and its policy, one, and then the second question is should there be or have you recommended someplace—I haven't seen it—some sort of a council that would meet with whomever the appointment of the Federal Reserve person would be to help guide this? And I am thinking about the other banking regulators who seem to have a great deal of knowledge and input. Would they serve on some sort of group that would advise or would all that be informal, or would they be formally members?

I would be interested in your comments about the Federal Reserve's ability to manage this kind of emergency at this point.

Mr. VOLCKER. Well, obviously, a very relevant question, is the Federal Reserve proposing or are other people proposing as things exist? Does the Federal Reserve take on too much? I don't think so. These are big responsibilities. But as I see it, there is a close relationship between banking and financial supervision and monetary policy.

I don't think monetary policy should be a matter of domain of a few economists sitting in a room deciding on the basis of various theories which are probably controversial, and what interest rates should be precisely where, and so forth. That is part of it. But I think that process ought to be leavened by knowledge and close contact with what is going on in financial markets.

Now, we have an example of that recently. The Federal Reserve was counting on monetary policy, but that got thrown off course and the economy got thrown off course completely by what was happening in the financial system outside the realm of monetary policy. Now, I think the regulators should have been on top of that a little better, although they are never going to be perfect. But we want to—I think we need a cross kind of fertilization between monetary policy and supervisory policy, myself.

It is an old concern—go back and you read the history of the Federal Reserve. Marriner Eccles in the 1930's, who was then the Chairman, complained bitterly about the fact that the Federal Reserve didn't have enough control over supervisory policy because in the middle of the Depression, he thought those other banking supervisors were being way too tough on banks and inhibiting bank lending. And he thought they were too easy earlier, when the economy was doing well.

Now, is the Federal Reserve going to do a better job? I don't know. I don't think they should be the only regulator. But I do think they are the logical ones to have this oversight responsibility.

And I also think, as you mentioned, if the Federal Reserve is going to remain in the regulatory supervisory business, I think the Congress should reinforce their responsibility by doing such things as having a particular Vice Chairman of the Board who is responsible for supervisory policy, and he knows that is his statutory function. There is nobody in that position now. The staff is going to have to be strengthened and enlarged and various other measures made.

Now, should there be a council? I have no problem with a council, and I think it would be useful, so long as there is somebody who is driving the process and is, in the end, responsible.

And the Treasury, as I read it, they don't quite say it this way, but I think what it amounts to, at the end of the day, the way the Treasury would do it is have the Treasury in that position. And I guess the way I would do it is I would have the Federal Reserve in that position, because I think it is a part of a natural central banking function.

It is interesting, this is in controversy all over the world, frankly, but in the U.K., which has gotten a lot of attention, supervisory authority was taken away from the Bank of England 10 years ago, more or less. And then when the crisis arose, they were kind of at sixes and sevens as to who was responsible and how the crisis arose; how did the regulatory agency—how was that too insensitive and why didn't the Bank of England know what was going on? And they had trouble coordinating the effort. And the Treasury got involved, too, as it naturally would, but at one point that was considered best practice: Take the regulation out of the Federal Reserve.

I don't think that is a strong opinion internationally anymore, after seeing the primary exponent, the U.K.—I can't say it fell on its face, but it didn't do very well when push came to shove, because the locus of responsibility was not clear.

The CHAIRMAN. Mr. Volcker, thank you. There is a lot of interest, so we are going to have to move on.

The gentleman from New York, Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman. Good to see you Mr. Volcker. We have been debating something within my office. I am going to make a quick statement and then just ask you if, in fact, you can give me your opinion on it; that we when we consider the issue of "too-big-to-fail" and moral hazard, we are basically trying to get firms and their investors to internalize the cost of negative externalities that they may present to the system as a whole. In other words, we want the capital costs and the capital structure and the appetite for the risk to reflect all the costs of the institution, both internally and externally.

And I think Larry Summers, when he was speaking before this committee earlier, said that if a firm is too big to resolve in an orderly manner, it is undoubtedly too big to run in a professional manner. In other words, if the senior management of a financial institution cannot present a plan that will convince the public and its regulators that it can disentangle and wind down its operations in an orderly manner, there is no reason to believe that this same management team can run the institution on a daily basis, because they themselves don't fully understand their own company.

And for this reason, I believe that a properly structured, comprehensive resolution authority is, in fact, the most critical pillar to managing the moral hazard of the "too-big-to-fail" and systemic risk going forward. And the reason for that is different than what has been commonly discussed. It seems to me that the strength of the resolution authority is that it makes debt capital markets work in concert with regulators, and debt presents multiples of equity on financial institutions' balance sheet and debt holders have the power of covenants to manage what they perceive as risk or threats to their privileges as debt holders.

With effective, credible resolution authority, bondholders will know that they can no longer rely on the government as an informal insurance policy on their debt. It is this expectation in the past that has allowed firms to become "too-big-to-fail" as debt markets and every incentive to provide nearly unlimited financing to the largest institutions, knowing that the larger it got, the more likely it was that the investment would be backed by the government in case of institution failure.

So I think that is the crucial area we are looking at, and I would like just to get an idea of what you think in that regard, because I think that is absolutely key as we move forward with reform, with regulation reform in this particular instance. I would love to get your opinion on that.

Mr. VOLCKER. I agree with the thrust of what you are saying. That is the burden of my testimony here this morning is that we do need such a resolution authority, for the reasons you described. Some of the approaches that the Administration has surrounded that with, I don't agree with. But the basic idea that you need that kind of authority is, I think, central.

Mr. MEEKS. Do you believe that, as a consequence of capital more accurately reflecting the full risk of investing in an institution, that it will increase with that the institution size and the level of global risk?

Mr. VOLCKER. Well, I hope we can get a realization of that; that the institution will be more careful and less risk-prone and less—

and the financial system and the economy will be less subject to their failure.

Mr. MEEKS. Thank you. I yield back.

The CHAIRMAN. The gentleman from New York, Mr. Lee, I believe, would be next.

Mr. LEE. Thank you, Mr. Volcker. It is a pleasure to have been listening to you this morning. I appreciate many of your thoughts. You touched on a lot of areas and I, like you in many cases, feel that you have to be very careful in how much farther we go along with expanding the Federal regulation. I think we need to have the right type of regulation in place with the right type of authority to those—in this case, the Federal Reserve. In many cases, I agreed with what you said.

You touched briefly on the issue when you have banking institutions getting in more riskier-type trades. And in your mind, how do you—is there a way to decouple that and ensure we provide solvency to this industry?

Mr. VOLCKER. Couple that with—

Mr. LEE. With the banking institutions right now. How do we decouple where they are getting into riskier trading type activities—do you have a solution on how we would be able to separate these in a logical manner?

Mr. VOLCKER. Well, I think some of the activities that I am concerned about are clearly enough defined so you can just, in effect, either put it in law or have clear that the supervisory authority will prohibit it.

The tricky area is I think trading, which we discussed a little bit earlier, because there is a kind of legitimate area of trading that a large bank anyway is going to engage in that is, in fact, considerably in the area of customer service. If a customer comes in and wants to sell some securities, they ought to be able to sell through a bank. And if a bank is going to handle that, it is going to have to have some kind of a trading operation, a foreign exchange operation.

But I think there is a—the borderline is fuzzy, but there is a clear distinction between customer-related trading activity and pure proprietary trading, which some of the big institutions label it that way. They have a proprietary trading desk, separately operated, sitting someplace else, as in the case of—

The CHAIRMAN. Mr. Volcker, could you speak into the microphone? You have to sacrifice politeness for audibility. So we need you to speak directly into the microphone. It is less important to be polite than to be audible, so don't look at who you are talking to.

Mr. VOLCKER. AIG is a good example of what I am worried about. It is not a bank, but it should be regulated, I think, naturally. But they had this trading operation, a little trading operation that made a lot of money for a while, and it got out of hand, mostly credit default swaps. Nobody was much looking at it. No regulator was looking at it.

It is an activity that if, better informed now, if a supervisor was looking at it and AIG was supervised—and they should be supervised—somebody should have raised a question. That is an activity that had nothing to do with your insurance business directly, or

out there on a trading operation to make a lot of money, and similarly to profit-making but not to the insurance business. Stop it. I mean, that was a clear enough case that you—

Mr. LEE. I am just bringing up AIG. With the knowledge that you have now, in retrospect, going back a year ago, how would you have handled this situation with AIG?

Mr. VOLCKER. It is a complicated situation. They had to make a very quick decision about an area that nobody could understand the full implications of. The regulators I am sure were not on top of this operation in London or Connecticut, or wherever it was being operated. And everybody got in over their heads, and they did what was necessary in a very disturbed situation to provide money. And it has become now, as you know, \$150 billion, \$180 billion, whatever it is; it is, you know, outrageous. But I understand how they got there. That is what we want to avoid.

And I might say, while it is not on the agenda today, and the Treasury didn't put it on the agenda, I would hope this committee would look at the question of national charters for insurance companies and bring them under—at least the big ones—under a framework so that something like AIG with similar problems can't arise in the future. I think a lot of the big insurance companies would welcome a national charter and the consistency that would provide, because—I don't want to commit them into the safety net, but I do think that they ought to be regulated in a consistent way.

Mr. LEE. Thank you.

The CHAIRMAN. Thank you, Mr. Volcker.

Let me just say, for your information, the question of an optional Federal charter for the insurance, particularly life insurance, is on the committee's agenda for probably next year. It just would be more weight than I think this issue could carry.

There will be a proposal made by some for a national insurance office to do some monitoring. But the question of an optional charter is a very important one. It is a request we get from the international community. There is a lot of resistance to it at the State Insurance Commission level here. But I did want to assure you—

Mr. VOLCKER. I know there is something short of a charter. I hope you would go further than what has been proposed.

The CHAIRMAN. Well, right now—that, right now, is much short of a charter. For next year, on this committee's agenda next year, will be the question of a charter, of an optional charter.

The gentlewoman from Illinois, for instance, has been very much interested in that, along with the gentleman from California, Mr. Royce. And I have assured them they will get a full hearing.

But it just, with the agenda this year, complicated by needing to deal with the issues from last year—but it is on the agenda.

Mr. VOLCKER. I am unaware of any other AIGs out there, so maybe you are all right at the moment.

The CHAIRMAN. Well, of course, AIG's regulator was the fearsome Office of Thrift Supervision, and we will be addressing that issue.

The gentleman from Kansas.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman. And, Chairman Frank, I ask unanimous consent that the resolution authority proposal by Tom Hoenig, president of the Federal Reserve Bank of

Kansas City, and his colleagues, as well as two of his recent speeches, be entered into the record.

The CHAIRMAN. Without objection, it is so ordered.

And, without objection, there will be general leave for any of the members or the witnesses to introduce into the record any material they would wish to insert.

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

Chairman Volcker, how do we end "too-big-to-fail?" I don't know if you have seen the recent proposal offered by Kansas City Fed President Hoenig and his colleagues. Their proposal on resolution authority lays out more explicit rules than the Administration's proposal of how a large financial institution Like Lehman Brothers or AIG could be resolved so the debt holders, shareholders, and management would be held accountable before taxpayers are asked to step in. If you haven't seen the Kansas City Fed proposal, I would like to provide to you a copy and I would appreciate your written comments, if you would please. Others suggest that we require the largest financial firms to undergo a regular stress test that would have aggregate information publicly released, even in good times. I know some have argued the list of these firms should remain confidential. But doesn't the market already know who these firms are, based on the last round of stress tests? How do you propose we create the right incentives for firms to maintain reasonable leverage ratios and strongly discourage "too-big-to-fail?"

Mr. VOLCKER. Well, I might say I become aware yesterday that a Kansas City bank had made such a proposal, but I haven't read it so I can't comment on it in detail.

Mr. MOORE OF KANSAS. I will forward this to you, sir.

Mr. VOLCKER. I am sure these are all directed toward the same problem that we have been discussing; in fact, all these questions this morning. How do you reduce the moral hazard problem? How do you—

Mr. MOORE OF KANSAS. Sir, excuse me. Could you pull the microphone just a little closer? I am having a little difficulty hearing you.

Mr. VOLCKER. I said, we have discussed in a number of these questions, and my opening statement, how we deal with this moral hazard problem. And in all these cases, I think, I believe in the Kansas City proposal, this idea of a resolution authority looms very large.

Just how you do that, you are going to find not the easiest drafting problem in the world, because it raises a lot of technical issues and legal issues, even constitutional issues, which have to be carefully thought through. But I do think it is possible.

There is clear precedent or clear analogous arrangements for the banking world. And so what needs to be done is extending that to the nonbanking world, without the implicit promise—and of course this is key—without the implicit assumption that Federal money will be provided in the case of the failing institution.

Mr. MOORE OF KANSAS. Chairman Volcker, as we consider monitoring for systemic risks, it seems to me that it would be helpful to ensure our inspectors general, the various financial agencies be also asked to help identify weaknesses in the regulatory structure and propose solutions.

Would you support formally connecting these IGs to create a financial watchdog council, where they would meet on a quarterly basis and be required to provide Congress an annual high-risk assessment report on the greatest risks and gaps in our financial regulatory system that need to be addressed? Would you support a proposal like that, sir?

Mr. VOLCKER. I think I would have to look at that before I have any comment. When I respond on the Kansas City thing, I will respond on that point.

Mr. MOORE OF KANSAS. Thank you, sir, very, very much. I yield back, Mr. Chairman.

The CHAIRMAN. The gentlewoman from West Virginia, Mrs. Capito.

Mrs. CAPITO. Thank you, Mr. Chairman. I think I am out of sync here. Sorry.

The CHAIRMAN. Yes. Well, I take—

Mrs. CAPITO. Well, I am in sync.

The CHAIRMAN. Well, on this issue I take instructions from the Minority, so Mr. Lance is next.

Mrs. CAPITO. Thank you, sir.

Mr. LANCE. Thank you very much, Mr. Chairman. Good morning to you, Mr. Volcker.

Regarding the whole issue of "too-big-to-fail"—and this is obviously of great concern to all of us—and regarding the issue of moral hazard, yesterday the Secretary of the Treasury indicated that in identifying tier one candidates, there would not be a list but the market would know who they were, based upon the criteria.

Is there any real way to resolve this situation? It seems to me that Wall Street will know who they are and that there will inevitably be moral risk, more hazard, as a result of the identification of tier one entities.

Mr. VOLCKER. I don't think—Put it positive. I think it is extremely difficult to designate in advance who is systemically important and who isn't, because you may even find some fairly small institutions, not mega-institutions anyway, that are playing a particular role in the market at a particular time and have had a lot of interconnections with other institutions that create a big problem. They create a clog in the resolution of credit default swaps or something. Arranging all this in advance, I don't know whether the Treasury would intend to announce it or not announce it or set out criteria or what.

Mr. LANCE. Not as I understand it, sir. There would not be an announcement as to which entities actually are on the list, and the list would not be public; but that based upon the criteria, that Wall Street could figure out who they are.

Mr. VOLCKER. Yes, well, I would think that is true. Wall Street would figure it out, so you would have to probably announce it in the end. And then you have the problem, is a particular institution in, or is a particular institution out? And I think we will find in calm circumstances, the institutions that are in would hate it, because they would have particularly tough capital requirements and feel uncompetitive. But as soon as a problem arose, the institutions who were out would complain that we are vulnerable and they are not.

Mr. LANCE. Yes. I perceive a situation where, at one stage in the economic cycle, people would lobby not to be in it, and then later they would lobby to be in it.

Mr. VOLCKER. I think it is not the happiest thing in the world, but I think you properly have to leave some ambiguity in this situation.

Mr. LANCE. Thank you, sir. This is a continuing issue on this committee, on both sides of the aisle, and it is not easily resolved. And I appreciate your thoughts on that.

I yield back the balance of my time. Thank you.

The CHAIRMAN. The gentlewoman from New York.

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman. And it is good to see you again.

I guess my line of questioning is, being that we are seeing, you know, the banks starting to come back and starting to loan—not as much as what they should—we are seeing the market coming back up a little bit. We see on TV that the banks and the financial institutions are spending millions of dollars with very nice fluffy ads to get customers to come back.

And I guess the question is: With all that we are going to be trying to do, how long is it going to be before they start taking more risk again?

And that is one of the concerns I have. You know, it used to be that all these corporations, they ran their business because of trust, trust of the American people. They have ruined that trust. We can stand here and sit here and try and make it better, but millions of people have lost their IRAs, they have lost their retirement funds. Many have had to stop their thoughts of even retiring. We can't make that up.

But one of the things that I am afraid of, and I am already starting to see it, is the financial system is prone to more systemic risks today than I think ever before. I think it would be a tribute to the creation of complex investments products such as credit defaults. I mean, they are already starting on coming out with new products. And yet, you know, I think everybody was sleeping at the wheel.

You talk about the Federal Reserve. No one did anything to really bring the attention to the authorities on the way they were supposed to. So how do we make that better? How do we get the industry, I guess, to have a moral backbone? That is the main point, and we can't legislate for that.

Mr. VOLCKER. Well, I agree with your concerns, and we have lost the sense of fiduciary responsibility that should inherently—

The CHAIRMAN. Into the microphone, please, Mr. Volcker.

Mr. VOLCKER. I am going to have to eat it.

The CHAIRMAN. Bring it closer to you. It will move, you don't have to bend. Move the whole thing closer to you.

Mr. VOLCKER. I have a lot of sympathy with what the Representative from New York is saying about the loss of a sense of fiduciary responsibility. And I would like to restore that to the banks as much as possible, because they should have it. I think it is kind of hopeless in terms of—just in personal capital market operators. A tremendous amount of money, as you well know, was made in the financial system. So the incentive to get back to the situation as normal, or what was considered normal before, is pretty strong

by the people who were participating. But, of course, it is that system that led us over the cliff, and with all the adverse consequences that were mentioned. And that is what we want to avoid in the future.

And you talk about the capacity to make up more and more new products, get around more and more regulation. It occurs to me, as I heard you speaking, that maybe the best reform we could make is have a big tax on financial engineers so that they can't make up all these new things quite so rapidly; because it is this highly complex, opaque financial engineering which gave a false sense of confidence, which broke down.

But you have outlined the challenge, and Treasury has tried to address it. The Administration has tried to address it. Many other people have made suggestions. I am making a few suggestions this morning. And you are going to have to decide. But you can't let it go without some important action.

Mrs. MCCARTHY OF NEW YORK. No, I agree with you. And I think important action is certainly where we are trying to go. And we are trying to find the right balance. Again, you know, we have a younger generation that we have been trying to convince that they should start saving. Saving in this Nation was at a zero rate before all this started.

Mr. VOLCKER. That is part of how we got in this problem.

Mrs. MCCARTHY OF NEW YORK. Exactly. And with that being said, though, always try to look for something good. People are cutting back on some of their extraordinary expenses. They are cutting back on using their credit cards. And I think it is a lesson that everybody has made. But with that lesson, I think the punishment was too much. And I hope that we do find the right balance, especially for the consumers. We have to start taking care of the consumers this time around. Thank you.

The CHAIRMAN. The gentlewoman from Kansas.

Ms. JENKINS. Thank you, Mr. Chairman.

Mr. Chairman, the Administration has said that one of the goals of its resolution authority is to inflict the cost of failure upon shareholders and bondholders. At the same time, Mr. Geithner has been unable to say that further bailouts of creditors will be off the table. In a world where the mantra has become "no more Lehmans," is the promise that haircuts will be inflicted upon creditors the least bit credible? And if it is not credible, doesn't that mean that the next crisis will be still bigger?

Mr. VOLCKER. The danger is that the spread of implicitly a moral hazard could make the next crisis bigger. It is not going to be next year. It is not going to be probably 4 or 5 years. But memories are dim. And we want to make a system such that we don't have a still bigger crisis 10 years from now. And if we do nothing and let moral hazard become even more accepted, I am afraid there is a real danger.

So you want this resolution system to do such things as creditors taking a haircut if they have to; or convert into stocks, and the stockholder will probably lose and lose completely. In many cases, there will be a forced merger or other actions that will not require the injection of government money that can stabilize the situation.

Now, that is more forceful than what happened in the midst of the great crisis a year ago when, by and large, with the exception of Lehman, the bondholders were pretty much protected in the financial world. They weren't protected in General Motors and Chrysler, but they were protected in the financial. And even some of the stockholders were protected.

Now, they did not lose as much as you might have thought they should have lost. We want to minimize that kind of result to the extent possible so that the lesson gets through: You creditors are taking a risk and you ought to understand that. And the government isn't going to come to your aid if this institution fails.

And this is the game. I hate to call it a game, but this is, I think, the approach that we are trying to instill, and make sure there is what is appropriate uncertainty, or maybe certainty, that if these nonbank institutions are going to fail, the creditors are at risk and the stockholders are at risk. And we do the best we can to do that without destroying the system.

Ms. JENKINS. Thank you. I appreciate your input. I yield back the balance of my time.

The CHAIRMAN. The gentleman from Massachusetts. This time, I saw you.

Mr. LYNCH. Mr. Volcker, thank you for your attendance and for helping the committee with its work. I was listening to your testimony outside and I was wondering, this whole framework that we are considering here—given the complexity of some of this, some of the instruments that are being traded now, the derivatives that we are now going to put on exchanges, and some that are not but necessarily require oversight, where we are entering new territory here which we hope will bring more effective regulation to the entire financial services industry. The question for us in part will be how to pay for that, how to pay for that structure.

And I know that the last time we had a great disruption here, the Great Depression, Congress and the financial services industry sat down and they derived a system that—I think it was one three-hundreth of 1 percent of every share traded on the exchanges would go in to pay for the SEC, for example. That number has been reduced over time because of the volume of trades.

But would you favor some type of—when we have to grapple with how to pay for all this, would you favor some type of system, some transaction fee, for example, that would help fund all of this? We have many, many of our constituents who don't have any—they don't have an IRA, they don't have money in the stock market. And yet if we use the general taxation authority, they too will be paying for this system that they don't necessarily benefit directly from.

And I was wondering if we could have your thoughts on how we might as a Congress pay for some of the regulation that we are about to implement.

Mr. VOLCKER. Well, just a general question has arisen from time to time in the past. It rose quite poignantly 20 or 30 years ago with respect to foreign exchange crises or foreign exchange operations, as to whether a little tax wouldn't do some good, both in raising revenues and in discouraging speculative activity. I think the conclusion of people who looked into that in the past was kind of two-fold. First of all, it is very hard to do it for one country in any sig-

nificant amount, because you force then, competitively, the market to another country that doesn't charge. So that is the number one problem. You have to get some consistency internationally.

The more general problem, I think, is if the fee is low enough not to be disruptive of markets, it is not going to raise much revenue. If it is high enough to raise some revenue, it will be disruptive. So you are kind of caught; and is there any middle ground?

But I think it might be interesting if the Congress suggested somebody look at this and see whether there is anything to the idea at all. You probably are aware that the head of the British Supervisory Authority has proposed—and I think he says he doesn't think it is going to happen—but he says just what you say: Maybe a little tax on the financial transactions would be a good thing.

It is very interesting. He says maybe the financial world, financial system, got too big in the U.K., it got too dominant. It made a lot of money, but it really didn't contribute to the national wealth of the United Kingdom. And he has raised some very interesting questions, including, I don't know how seriously, the question of this tax. But he has a point.

You are probably familiar with the fact that the world of finance at one point, in terms of its total profits, came to almost 40 percent of all the profits in the United States. And that doesn't even count all the bonuses. That is after the bonuses.

And you know, some people raised the question, I raised a question of whether the value, really, of the world of finance is 40 percent of the United States and things haven't gotten a little out of bounds here, which is what you are struggling with in a general sense. How is this great industry of finance, harnessed to do the job it is going to do, an absolutely indispensable job, without taking risks that for a while were very profitable, and then it turned very sour. How do you get the job done, done in a way that—of course, smart men can make reasonable returns without placing the whole economy at risk.

The CHAIRMAN. The time has expired. Mr. Volcker can stay until 11:30. There are 10 members present who haven't asked questions. I will announce on the Democratic side that I will give priority to the people who were here. That should accommodate everybody who was here. If no new members come on either side, everybody who sat through it can do it. The Minority can make its decisions. But with Mr. Volcker's agreement, that will give us 10 people an hour. We will hold people strictly to 5 minutes. And in fairness to the people who were here, that is the way we will go.

So now it is up to Mrs. Capito.

Mrs. CAPITO. Thank you, Mr. Chairman. Thank you, Mr. Chairman, for being here.

I would like to go to the resolution authority that the Administration has proposed. Those of us—we put together a Republican plan to deal with re-regulation and new regulation. And one of the ideas that we put forward was an enhanced bankruptcy rather than a resolution authority by the Reserve. And I think in doing that, I think we were—we feel that it creates more transparency, accountability; it can go into the bankruptcy court, with the accompanying experts in that bankruptcy court that would understand the complexity of what is going on. And also, it would remove, I

think, any kind of appearance of a bailout or another implicit or implied government backstop.

Do you have an opinion on an enhanced bankruptcy as opposed to the resolution before you?

Mr. VOLCKER. I haven't seen your proposal so I can't comment in detail. But I think the problem that we are all dealing with is when the emergency comes, you don't have much time. And it looks efficient anyway, to say okay, the government had to take action immediately. We are going to put somebody in there to run this organization, and it can do what it can do in terms of, for instance, doing the kind of thing with the creditors that a bankruptcy court might eventually do. But you don't have a month to work it out. You don't have 2 months to work it out. You don't have a week to work it out. You don't have days to work it out. You have to do it right away, or at least plan it right away.

So that is, I think, the problem that we are dealing with, the ordinary bankruptcy-type negotiated settlements which work okay when you don't have a systemic risk. That is a day-by-day affair. You have to deal with it immediately. And that is, of course, the problem we ran into a year ago.

So within that constraint, if you have a better way of doing it, good; but I think it has to recognize that constraint.

Mrs. CAPITO. All right, thank you.

My last question is, so many of these matters—I mean you have dealt with these matters your entire life and done such a wonderful job. They are so darn complicated for the man on the street who is listening to this hearing.

Or any time I go to my district and try to talk about the need for new regulation in the financial markets, people's eyes start to glass over. And I know you have made many speeches and many—is there any way, in a concise way, besides, you know, this is going to protect you from losing your retirement in the future—is there any way that you find is most effective to convey the message to the man on the street that this is an issue that really does impact them every day in their life?

Mr. VOLCKER. Well, it would be no comfort to you that I find it too damn complicated myself, so it is very complicated. But I think the message that you have to give them is, the whole object of this exercise is to prevent a repeat of what has happened. And it is not just a loss of finance, which is obviously important, particularly the loss of retirement funds and all that kind of thing. That is serious enough. But it has also affected the operation of the economy. So people lost jobs, and we are left with a big recession, we are left with a situation where it is going to be a tough recovery.

So we are dealing with a big problem—you are dealing with. And I wish it was simpler, but it is not very simple because the finance system itself has gotten so complicated. I think that is part of the problem, frankly. I mean, I think I have made remarks about financial engineers. I am more than half serious about that, because it has gotten so complicated. I am sure the management of most financial institutions don't understand what people are doing down in the bowels of the institution, in some very fancy bit of financial engineering. And they get told, as I am sure in the case of the subprime mortgage, we have it all figured out. These are lousy

mortgages but we have them all put together in a way that is perfectly safe and they are triple A. So you can buy them and you can pay.

And I don't think the managements in most cases, you know, were able to see through that, understandably, because it is very complicated. Now I think the cloud before the eyes has been removed, and we ought to take advantage of that and try to make sure it doesn't return.

Mrs. CAPITO. Thank you. I yield back.

The CHAIRMAN. The gentleman from North Carolina, Mr. Miller.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Volcker. Last fall when Lehman collapsed and AIG was rescued, I felt like I was not a sufficiently conscientious member of this committee, because I so little understood credit default swaps which had played such a huge role in all that. And then I came to realize that no one understood them, which made me feel a little better about my own level of conscientiousness, but maybe feel worse for the economy of the country and of the world.

In your testimony, you identified credit default swaps as something that had exacerbated the risks that our entire economy faced, the Nation's economy and the world's economy. The usual justification is risk management. They are like insurance. But the great, great bulk of credit default swaps and other derivatives are between parties, none of whom have any risk to manage. They have no interest in the underlying whatever it is.

You, in your testimony, said some kinds of risky behavior should not be allowed of institutions that are systemically important. Do you think credit default swaps, for instance, where nobody in the contract has any interest in the underlying security, should be allowed of systemically important institutions?

Mr. VOLCKER. Well, let me just make a general kind of philosophic question, and then credit default swaps. My general position is you make a distinction between banks and others. Banks are going to be protected. They are protected in other countries. They have been protected here for a century. That is not going to change, shouldn't change, I don't think. But let's not extend that protection to the whole world.

Now we get the credit default swaps which are out there in the market and arguably serve a legitimate function in a trading operation of protecting the holding of a bond against the default on the bond. But it became a big kind of speculative market, trading market, so you had many more credit default swaps outstanding than there were credits, which raises some questions about the functioning of the market, and how the basic purpose it was serving was underlying and had a purpose. But the market was developed in a way that it was vulnerable to collapse—if that is the right word—if it came under great strain. And it came under great strain because AIG was so central to the market. Now, that had been of concern, frankly, before. Some people understood this before the crisis, and, on a voluntary basis, began introducing measures—

Mr. MILLER OF NORTH CAROLINA. You do need to eat your microphone. I am having a really hard time hearing you. Sorry.

Mr. VOLCKER. I said people had begun working on the credit default swap problem in terms of the clearance and settlement procedures, even before the crisis, on a voluntary basis, with some success and some great effort. Now the crisis has exposed it and the government stepped in and made proposals. I don't know how many of them require legislation. At some point, it will require some legislation.

But now there is a lot of progress in forcing this trading into clearinghouses or organized exchanges with the whole panoply of rules that implies, collateral requirements, protection against default and so forth. So that is a big step forward.

You might not have had the AIG problem which has loomed so large, had all those arrangements been in place before, because there were no agreed—well, there was an appropriate basis in that respect, some agreed conventions, but AIG did not sufficiently collateralize and protect against risk, given what happened. They thought they had no risk because they were so big and strong. Well, when they weren't so big and strong, you had a problem. That is a big problem, and it is one of the areas in which I am sure that big progress is going to be made and is being made.

Mr. MILLER OF NORTH CAROLINA. Do you think that the margin requirements to the collateral requirement is sufficient with respect to—

Mr. VOLCKER. Well, somebody ought to be in a position to make sure that it is sufficient. I am not an expert. I can't judge whether they are sufficient or insufficient. Somebody ought to be deciding that.

Mr. MILLER OF NORTH CAROLINA. Are there any collateral default swaps, credit default swaps, other derivatives, that should require an insurable interest by somebody in the transaction? Should there be a requirement with respect to any credit default swaps of an insurable interest?

Mr. VOLCKER. I think this whole market needs to be brought under surveillance, and you ought to provide the authority that somebody can have adequate authority to satisfy themselves the market is sanitized.

Mr. MILLER OF NORTH CAROLINA. My time has expired. Thank you.

The CHAIRMAN. The gentleman from Texas.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. Thank you, Chairman Volcker, for being here.

Looking back at your experience at the Federal Reserve, one of the things that is out there today is that the Federal Reserve would designate these tier one companies in financial institutions. And a lot of people believe that when you say that company is tier one, that they are in fact "too-big-to-fail." And so there is an implicit guarantee there that these are entities that we are not going to let fail.

The question I have for you is: Is that good for the marketplace, and is that good policy?

Mr. VOLCKER. No, I don't like that idea. That is part of what I am saying here. Trying to identify these institutions in advance as a special interest, whether they say it or not, then carries the connotation in the market that they are "too-big-to-fail." And I think

that adds to the moral hazard problem. Most of what we have been discussing this morning is how to corral moral hazard. And I don't think that is—that is not the way to do it. It doesn't corral it, it extends it.

Mr. NEUGEBAUER. I have heard you say—and I think this is something that you and I agree on—that capital could have cured a lot of the ills that we faced in the country over the last year if these companies had actually been capitalized to a level sufficient and commensurate with the risks and exposure that they were taking.

Is it a better strategy, in your opinion, for the regulatory agencies, the regulators, that when these entities are very diverse, involved in a lot of different activities, that they actually do a better job of breaking down the businesses that each one of these entities is in, and assigning capital requirements for those activities; and so then, if that entity wants to continue that business activity, it understands that it will have to have a certain amount of capital to do that, and the marketplace then, in effect, begins to analyze those businesses and ascertain whether they want to furnish the capital to those institutions? And so don't you have a check and balance from the marketplace as well as the regulatory structure?

Mr. VOLCKER. I think capital requirements and amount of capital are obviously important. But if you try to fine-tune it too far—the banking regulators have struggled with this—how much capital in each particular kind of risk basket? It is very hard to define different risks very precisely.

And they went from a system, or trying to go from a system that was very crude, back when I was Chairman of the Federal Reserve—which we had installed—to say it is not sophisticated enough, it doesn't have all those baskets that you are talking about. But boy, they have run into more difficulty. They have spent 10 years trying to define this and they put a lot of weight on credit rating agencies. Now, that no longer looks so great. But that is illustrative of the kind of problem you run into.

So I am kind of on the side of, yes, adequate capital. Yes, make sure capital is big enough, but recognize it has to be pretty crude, and don't try to be too sophisticated about it.

I do think, and you may be getting at this, when you get into nonbanks, bank capital is already—whether it is adequate or not, no doubt it is a matter of a supervisory concern. When you get outside of the banking system, then I think there ought to be some residual authority for those few institutions that get so big they really look dangerous from the standpoint of financial stability, somebody has the authority to say, look, you are too leveraged. You have to provide some more capital, or you have to cut down on your assets; or you cut down on your activities and you have to hold more liquidity. I think the need for that will be rare.

I do believe in registration of hedge funds, I do believe there ought to be some reporting of hedge funds. But I think there are very few hedge funds that present a systemic risk. They are a different kind of operation, a different kind of financing. We have seen failures of hedge funds that were successfully absorbed without much difficulty. Interestingly enough, where that was not true was the hedge funds owned by Bear Stearns. What sent Bear

Stearns in the beginning of its downward slide was the failure of or losses in its own hedge funds, which is illustrative of why I don't want commercial banks to be holding hedge funds, because that would be a point of vulnerability.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. We have votes, unfortunately. We can't hold Mr. Volcker after this. We will have time for two more questions for people who have been here, and then we will break. We will resume, and we will start with those who were here and didn't get to ask.

The gentleman from Georgia.

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. Volcker, let me ask you to comment on the whole issue of "too-big-to-fail," because I think that we have not paid attention to what happens as a result of that. The consequence becomes what do we do; do we have a strategy; does that strategy lead to another strategy called too-small-to-save? And I think that is where we are.

Historically, if we looked at the Depression that we went through, it was these smaller banks, banks went under, they never came back. Eventually, smaller banks began to serve a niche. I am very concerned about the future of our smaller banks, our community and regional banks. And are we at the point, as a result of this rush to save these large banks, holding companies, there isn't that much attention that we are faced with in terms of these smaller banks. Bank after bank after bank has gone under across this country. They haven't been the Bank of Americas or the SunTrusts or the national banks, the big banks. They have been these community banks that actually provide the monies for these communities.

One of the big problems we had, for example, with the automobile dealers was the fact that once the automobile manufacturers had a problem, the automobile dealers had a problem, but it wasn't—their problem was the inability to get money.

So the problem here becomes, I think, we are glossing over a deeper problem here of getting down to the grass roots in these communities. Unemployment is not going to bounce back until we get these small businesses thriving. The small businesses are getting their monies from the smaller community regional banks. And yet because of this overemphasis on this "too-big-to-fail" strategy, we are losing the bigger picture, it seems to me; and as a result, we are left with too-little-to-save.

Could you comment on this particular predicament we are in?

Mr. VOLCKER. Well, I am not sure how helpful I can be. I think there is a problem. Obviously you are seeing a lot of failing of small banks, and they are kind of easy to take care of in terms of the capacity of the FDIC, and disturbance or lack thereof, and the failure of a particular small bank. But I do think that it takes judgment. But in a particular case of a small bank, to what extent is the problem one of accounting practice maybe, and I think bank accounting needs some review. I am not sure how important that is to these smaller banks.

Are their cases where—bad word, but I will use it—that forbearance would have been justified, and the benefit of the doubt in some sense given to the small bank to see whether it can hold together for a while without forcing it into either a merger or liquida-

tion? I don't know. That takes a very sophisticated and understanding regulatory regime, which may be beyond us.

Mr. SCOTT. Do you see a future for the small community regional banks?

Mr. VOLCKER. Look, I am old-fashioned. I see a future for small- and medium-sized community banks because they have some inherent advantages in dealing with local communities and the small borrowers and the individuals that are concerned. I think they can be quite competitive. And they are not a danger to the country. Quite the contrary. What I think we ought to do is we ought to be conscious that we are not unconsciously undercutting them. But I don't have any magic answers to that.

Mr. SCOTT. All right. Well, thank you very much.

Let me just ask you one other question here. I have a few more minutes. Over the past 6 months, loans and leases have declined at a record annual rate of 8 percent with no hint of an upturn, despite the Fed's massive effort to get credit flowing. Credit is still not flowing sufficiently to assure a strong and sustainable economy.

Do you believe this to be a two-sided problem? One, reduced willingness of banks to lend amid the record loan delinquencies; and, two, the subdued desire to borrow.

Mr. VOLCKER. Well, bank lending, I guess, is declining. This is an area of the market that is still clogged up. It is a matter of confidence in part, in large part. And a lot of them are in financial difficulty. And I think it is going to take time for that to unlock. The big market has opened up considerably, but the small bank market has not, although there are some signs it is beginning to change. So I hope that we can see evidence of that before too long.

Mr. SCOTT. Thank you, Mr. Volcker.

Mr. MILLER OF NORTH CAROLINA. [presiding] Thank you. Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. And, Chairman Volcker, over here. The good news is I appear to be your last questioner of the morning. Thank you for your time, sir.

I want to follow up on a line of questioning from my colleague from Texas, Mr. Neugebauer, and try to put a very fine point on it, perhaps a theoretical point. He was inquiring about, in retrospect, could the regulators, had they had I suppose more perfect knowledge in being able to assess risk, could they not have applied the proper capital and liquidity standards, be it to our insured institutions or our investment banks? At least, theoretically, had they known, could you have applied proper capital and liquidity standards to perhaps have prevented the economic turmoil that we saw?

Mr. VOLCKER. I think the answer is, theoretically, yes. But the answer may also be, practically, no. I don't mean to be that negative. But the problem with banking supervision, the chronic problem is when things are going well, nobody wants to hear from the supervisor, including Congress, doesn't want to hear about restrictions. And you will get complaints from your constituencies: "What are those big bad regulators doing demanding higher capital requirements and preventing me from doing this or that?" "I never failed," the argument will be, "and I am doing fine. Leave me alone." And then, of course, when things happen, where were they?

Mr. HENSARLING. But I guess for a historical perspective—and I guess I would ask if you agree or disagree—at least with respect to our insured institutions, the prudential regulators had the ability to take prompt and correct action.

Mr. VOLCKER. I think there was some failure in banking supervision.

Mr. HENSARLING. Perhaps they lacked the expertise, perhaps they lacked the courage, forethought, but they didn't really didn't lack the regulatory authority to have imposed a capital or liquidity standard that would have been commensurate with the risk.

Mr. VOLCKER. I think there are two things in particular that I would say directed toward that. First of all, I do think that the idea of having an overall overseer to kind of look at things, whether capital standards generally are adequate, whether the liquidity standards are adequate, whether some trading operations are developing that are destabilizing. We haven't had anybody overtly and specifically charged with that kind of responsibility. We have individual agencies looking at individual banks, yes, and they are worried about capital. But they don't take a fully systemic view, by nature of their responsibilities.

I also think, so far as the Federal Reserve specifically is concerned, if they are going to carry heavy supervisory responsibility, I think there does need to be some internal reorganization in the Federal Reserve to make sure that the Board itself, the Chairman and the Board itself, are sufficiently invested with the responsibility for regulation and supervision. And explicitly I have suggested, other people have suggested, that there be created a position of Vice Chairman of the Board for Regulatory and Supervisory Practice, so that there is no doubt on your part as a Congressman as to who in the Federal Reserve is supposed to be on top of that.

Mr. HENSARLING. Chairman Volcker, let me turn to the question of resolution authority. And clearly, there are differences within this body on how best to do that, be that through some type of greater expert enhanced bankruptcy process versus perhaps the Federal Reserve undertaking this particular duty.

I believe I heard Chairman Frank, yesterday, say that whatever the resolution authority—and I know he is not in the Chair at the moment—what I believe I heard he said, at least from his perspective, is that resolution authority essentially ought to be a death sentence, which I believe I interpreted to mean that he would favor receivership over conservatorship.

We presently have Fannie Mae and Freddie Mac and AIG in forms of conservatorship, with massive transfusions of taxpayer money, with no exit strategy, no end in sight for the taxpayer.

Whatever resolution authority may come out of the United States Congress, could you speak to us about your opinion on whether or not it should have the ability to place these into conservatorship versus receivership and the pros and cons associated with that?

Mr. VOLCKER. I think there ought to be authority for both. Conservatorship, implying this is an institution that has enough viability to be reorganized and be merged and revitalized; and receivership, liquidator.

Mr. HENSARLING. Would you put AIG in the category of a firm that—

Mr. VOLCKER. I am not the regulator of AIG. I don't have any knowledge of all of AIG. I know it is very, very complicated, complicated enough that I haven't wanted to get involved.

Mr. HENSARLING. We are out of time. Thank you, Mr. Chairman.

Mr. GREEN. [presiding] Thank you.

Mr. Volcker, because time is of the essence, I am going to move rather quickly to my questions, and there are only two. The first has to do with the notion that, metaphorically speaking, this economy had a toothache. And many times when you have a toothache, you will do anything to get rid of it. But once you are rid of it, you don't have the same memory of the pain that you had at the time you had the toothache.

And the reason I use this metaphor is because I want you to tell me just how bad it was. You spoke in terms of the economy going off a cliff. Tell me how bad was it when we interceded? How bad was it?

Mr. VOLCKER. Bad. Very bad.

Mr. GREEN. Compared to the Great Depression, let's call the Great Depression a 10. If it was a 10, how bad was this situation, Mr. Volcker?

Mr. VOLCKER. Well, the disturbance was very large, but of course, extremely forceful action was taken to curb the deterioration. But as you know, for a couple of quarters, the economy went down very rapidly, and part of the problem was it was not only in the United States. It became a worldwide phenomenon, a worldwide—I shouldn't say worldwide. It became a phenomenon among almost all well-developed countries.

So you had a situation that could feed upon itself, there was no strong point of growth in the world economy. So it was bad.

It is impossible to tell what would have happened without the massive government support. But you knew at that point and even now, the financial system was based upon government support. And that is not the kind of financial system we want to have. It is not what we talk about as a free enterprise system.

Mr. GREEN. When you use the term "going off a cliff," sir, give me a little bit more of what that means, "going off a cliff."

Mr. VOLCKER. It meant that, the falling-off-the-cliff analogy applied to the rapid decline in the economic activity for 6 months or so, which found its expression, cause, the rapidity of it, in that the supply of credit dried up. Banks were not lending. Banks could not lend. The open market was constipated. So there was no availability of credit, and that led to, obviously, difficulties in carrying on economic activity.

Mr. GREEN. I am going to ask one final question, and because my friend and I have different views on this, I am going to stay and give him an opportunity, because he may want to have a follow-up on this question. I think it is only fair to do so.

Mr. Volcker, was the CRA the cause of this crisis that you and I just finished discussing?

Mr. VOLCKER. What was the cause?

Mr. GREEN. Was the CRA, the Community Reinvestment Act, the cause?

Mr. VOLCKER. Was the Community Reinvestment Act the cause?

Mr. GREEN. I don't mean to insult your intelligence, but it is important that I get this on the record. Was the Community Reinvestment Act the cause?

Mr. VOLCKER. A cause?

Mr. GREEN. The cause.

Mr. VOLCKER. I don't believe that it was a significant factor in this situation.

Mr. GREEN. Now, because we are short on time, sir, could you—

Mr. ROYCE. I will be very brief.

And, by the way, we go through a routine where we ask if the Government-Sponsored Enterprises, Fannie Mae and Freddie Mac, were one of the causes, the lack of regulation over them, and then that gets translated, but that is not what I am interested in today.

Mr. VOLCKER. I am willing to inject a comment here.

Mr. ROYCE. Yes?

Mr. VOLCKER. Please do not recreate Fannie Mae and Freddie Mac in the form of these hybrid institutions, half private, half public.

Mr. ROYCE. So you think that the GSEs were one of the causes?

Mr. VOLCKER. I think they were a factor, yes.

Mr. ROYCE. Okay, then, let me ask you a question. The Richmond Fed economist, back in 1999, said 27 percent of all of the liabilities of firms in the U.S. financial sector were explicitly guaranteed by the Federal Government; another 18 percent enjoyed some implicit support. That would be 45 percent. Now that is back 10 years ago.

Now we look at March of 2008 when the New York Fed stepped in and assumed the risk of about $30 billion in the portfolio of the investment bank Bear Stearns. So we have seen this rapid expansion of both the perceived and the actual financial safety net, the explicit financial safety net. Do you think the expansion of this safety net has exacerbated the "too-big-to-fail" problem?

Mr. VOLCKER. Yes, and I think the whole—90 percent of the discussion we have been having here is trying to figure out some way of pulling that back.

Mr. CLEAVER. I am going to have to ask Mr. Volcker to give the rest of his response in writing. We have exceeded our time and are to zero on our voting—

Mr. ROYCE. Sure enough.

Mr. CLEAVER. If I may say so, Mr. Volcker, we thank you for being here, and I do this on behalf of our Chair, and we thank all of the other panelists for being here. We are coming back after this vote.

Mr. Volcker, you are excused, and it is with great pleasure that we have had you here today.

Thank you, sir.

Mr. VOLCKER. Thank you for having me.

[recess]

Mr. CLEAVER. [presiding] I think we will go ahead and begin with our testimony. We appreciate all of you donating your valuable time and intelligence to this committee today.

We are going to begin with the Honorable Arthur Levitt, Jr., the former Chairman of the SEC and Senior Advisor to the Carlyle Group.

Mr. Levitt.

STATEMENT OF THE HONORABLE ARTHUR LEVITT, JR., FORMER CHAIRMAN OF THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION; SENIOR ADVISOR, THE CARLYLE GROUP

Mr. LEVITT. Thank you for the opportunity of appearing before the committee to discuss the critical issues of establishing a systemic risk regulator and a resolution authority. I will summarize my prepared statement, which I have submitted to the record.

As a former Chair of the SEC and currently as an advisor to Getco, The Carlyle Group, and Goldman Sachs, I hope I can share with you important considerations to inform your efforts.

Though the appetite for reform appears to move in inverse relationship to market performance, financial markets are no less risky and regulatory gaps remain. I am concerned that public investors may well be convinced because of the relative market calm of the last few months that all is well in our regulatory system, but all is not well and I am glad you are showing leadership in addressing these issues.

Your success will be determined by how well you affirm the principles of effective financial regulations, principles relating to transparency and regulatory independence, the proper oversight of leverage and risk taking, the nurturing of strong enforcement, early intervention, and the imposition of market discipline.

One of the key questions before this committee is how to authorize and hold accountable a systemic risk regulator and who should provide this function. I would like to suggest that the more critical question is whether any regulator or groups of regulators can have the same impact as well as a resolution authority. Such an authority would be created explicitly to impose discipline on those with the most power to influence the level of risk taking, the holders of both equity and debt in institutions which may be "too-big-to-fail."

A systemic risk regulator will not be effective unless you also create a resolution authority with the power to send these failing institutions to their demise and thus impact the holders of both their debt and equity.

To give a simple analogy, it doesn't matter who serves as the cop on the beat if there are no courts of law to send law breakers to jail.

I strongly believe that a systemic risk regulator must serve as an early warning system with the power to direct appropriate regulatory agencies to implement actions. I am agnostic about who should lead such an agency and perform this function, and I would caution against making the Federal Reserve the systemic risk regulator in its present structure.

The Fed's responsibilities to defend the safety and soundness of financial institutions and to manage monetary policy creates inevitable and compromising conflicts with the kind of vigilance and independent oversight a systemic risk regulator requires. If, however, the Fed is deemed to be the best available place for this role, I would urge Congress to remove from the Fed some of its responsibilities, conflicting responsibilities, especially those of bank oversight.

In many respects, the surest way to cause investors, lenders, and management to focus on risk is not to warn them about risk but to give them every conceivable way to discover risk and tell them what will happen to them if they don't pay attention.

We can deal with this by establishing a resolution authority charged with closing out failed institutions which pose systemwide risk. Such an authority would have the power to do just about anything to put a failing bank in order or close it down in an orderly way without, if possible, further government assistance. It could terminate contracts, it could sell assets, cancel debt, cancel equity, and refer management for civil penalties for taking excessive risk even after multiple warnings.

I would expect that managers, customers, creditors, and investors would become a good deal more careful, having foreknowledge of their potential rights and responsibilities should such a resolution authority be activated. They would see the advantage of greater transparency and developing more knowledge of individual institutions, and this market discovery may well do the work of many outside systemic risk regulators.

Of course, your goal is to incentivise market discovery. You will also want to establish the value of transparency with respect to market information. I want to emphasize in particular the importance of fair value accounting for major financial institutions engaging in significant amounts of risk taking and leverage. Such accounting gives investors a true sense of the value of an asset in all market conditions, not just those conditions favored by asset holders.

Greater transparency would make it possible for market participants to price risks appropriately and for a systemic risk regulator to demand fresh infusions of liquidity or higher margin requirements if needed.

I would much prefer that a systemic risk regulator be so effective that a resolution authority would be unnecessary. But sadly, we know that always preventing failure is absolutely impossible. I think it is, therefore, in my opinion, your job to make failure possible.

Thanks again for your attention to these issues, and I urge you to continue to accelerate your efforts.

[The prepared statement of Mr. Levitt can be found on page 62 of the appendix.]

Mr. CLEAVER. Thank you, Mr. Chairman. The next witness, Mr. Jeffrey Miron, is a senior lecturer and director of undergraduate studies in the Department of Economics at Harvard University.

Let me ask the three remaining witnesses, because of the possibility of another vote in maybe 25 or 30 minutes, I am going to ask if you can still push out the most significant parts of your testimony. But perhaps at the end if you could summarize them so we can make sure that all of you are able to complete your testimony before any vote call.

Thank you.

STATEMENT OF JEFFREY A. MIRON, SENIOR LECTURER AND DIRECTOR OF UNDERGRADUATE STUDIES, DEPARTMENT OF ECONOMICS, HARVARD UNIVERSITY

Mr. MIRON. Thank you, Mr. Chairman, Ranking Member Neugebauer, and committee members. Let me begin by expressing my thanks for the opportunity to present my views on this matter. The question I will address is whether Congress should adopt Title XII of the proposed Resolution Authority for Large Interconnected Financial Companies Act of 2009. This Act would grant the FDIC powers for resolving insolvent financial institutions similar to those that it currently possesses for revolving banks. My answer to this question is an emphatic, unequivocal "no."

Let me explain. The problem that resolution systems attempts to address is that when our financial system fails, the value of the claims on that institution's assets exceed the value of the assets themselves. Thus, someone must decide who gets what, and it is impossible, by virtue of the assumption that we are dealing with a failed institution, to make everyone whole. The size of the pie owned by the failing institution has shrunk so those who are expecting a slice of that pie collectively face the necessity of going somewhat or substantially hungry. The resolution authority decides who gets what, but the reality is that someone has to go wanting.

It is in society's broad interest to have clear, simple, and enforceable procedures for resolving failed institutions, principally to ensure that investors are willing to commit their funds in the first place. If the rules about resolution were arbitrary and ever-changing, investors would be loathe to invest and economic investment productivity and growth would suffer.

A well-functioning resolution process is part of a system for defining and enforcing property rights, which economists agree is essential to a smoothly functioning capital system.

The crucial thing to remember here is that someone has to lose. Just as importantly, it is valuable to society as a whole, although not to the directly-harmed parties, that those invested in the failed institutions suffer economic losses. This releases resources to better uses, provides signals about good and bad investments and rewards those who have made smart decisions.

The flip side of the fact that standard resolution systems, like bankruptcy, impose an institution's losses on that institution's stakeholders, is the fact that a standard of resolution authority, such as the courts, puts none of its own resources into that institution. The resolution authority is resolving claims and dividing the pie but is not adding any more pie.

Under the bill being considered, however, the FDIC would have the power to make loans to the financial institutions to purchase its debt obligations and other assets, to assume or guarantee obligations and so on. This means the FDIC would be putting its own, that is, taxpayers' skin in the game, a radical departure from standard bankruptcy and an approach that mimics closely the actions that Treasury took under TARP. Thus, this bill institutionalizes TARP for bank holding companies.

A crucial implication of this departure from standard bankruptcy is the taxpayer funds foot the bill for the loans, asset purchases, guarantees, and other support that FDIC would provide to prevent

failing institutions from going under. These infusions of taxpayer funds come with little meaningful accountability, and it would be hard to know when they have been paid back and often that will not occur. The proposed new authority for the FDIC also generates the impression that society can avoid the losses that failure implies, but that is false. The proposed FDIC actions would merely shift those losses to taxpayers. The new approach is institutionalized bailouts, plain and simple.

Thus, under the expansion of FDIC authority to cover nonbank financial institutions, bank holding companies will forever more regard themselves as explicitly, not just implicitly, backstopped by the full faith and credit of the U.S. Treasury. That is moral hazard in the extreme and it will be disastrous for keeping the lid on inappropriate risk taking.

The right alternative to expanding FDIC authority is good old-fashioned bankruptcy. It has become accepted wisdom that bankruptcies by financial institutions cause great harm, and it is asserted in particular that letting Lehman Brothers fail was the crucial misstep last fall. In fact, nothing could be further from the truth.

As I explain in more detail in my written testimony, the ultimate causes of the financial crisis were two misguided Federal policies; namely, the enormous subsidies and pressure provided for mortgage lending to non-creditworthy borrowers and the implicit guarantees provided by both Federal Reserve actions and the U.S. history of protecting financial institution creditors. These forces generated an enormous misallocation of investment capital, away from plant and equipment towards housing, created the bubble, and established a setting where numerous financial institutions had to fail because their assets were grossly overvalued relative to fundamentals. Lehman's failure was one part of this adjustment, and it was a necessary part. If anything, too few financial institutions failed since the massive interventions in credit housing markets that have occurred in the past year have artificially propped up housing prices, delaying the adjustments.

Thus, the better way to resolve nonbank financial institutions is bankruptcy, not bailout. That is not to say existing bankruptcy law is perfect. One can imagine ways it might be faster and more transparent, which would be beneficial, nor should one assume that had bankruptcy been allowed to operate fully in the fall of 2008, the economy would have escaped without any pain. A significant economic downturn, in particular, was both inevitable and necessary given the fundamental misallocation of capital that occurred in the years before the panic, but nothing in the data, historical data or recent experience, suggests these bankruptcies would have caused anything worse than what we experienced and broader bankruptcies would have helped eliminate more hazards going forward.

In light of these assessments, I urge the members of this committee to vote against this bill since it codifies an approach to the resolution that is fundamentally misguided. We need to learn from our mistakes and trust bankruptcies, not bailouts, going forward as we should have done in the recent past.

[The prepared statement of Mr. Miron can be found on page 66 of the appendix.]

Mr. CLEAVER. Our next witness is Mr. Mark Zandi, the chief economist and co-founder of Moody's Economy.com.

MARK ZANDI, CHIEF ECONOMIST AND CO-FOUNDER, MOODY'S ECONOMY.COM

Mr. ZANDI. Thank you to the members of the committee for the opportunity to testify today. My remarks are my personal views and not those of the Moody's Corporation, my employer.

The Obama Administration's proposed financial regulatory reforms will, if largely enacted, result in a more stable and well-functioning financial system. I will list five of the most important elements of the reform, and I will make a few suggestions on how to make them more effective.

First, reform must establish a more orderly resolution process for large, systemically important financial firms. Regulators' uncertainty and delay in addressing the problems at Lehman Brothers and AIG, in my view, contributed significantly to the panic that hit the financial system last September.

Financial institutions need a single, well-articulated, and transparent resolution mechanism outside the bankruptcy process. The new resolution mechanism should preserve the system of stability while encouraging market discipline by imposing losses on shareholders and other creditors and replacing senior management. Charging the FDIC with this responsibility is appropriate given the efficient job it does handling failed depository institutions.

I think it would also be important to require that financial firms maintain an acceptable resolution plan to guide regulators in the event of their failure. As part of this plan, institutions should be required to conduct annual stress tests based on different economic scenarios similar to the tests that large banks engaged in this last spring. Such an exercise, I think, would be very therapeutic and would reveal how well institutions have prepared themselves for a badly-performing economy.

Second, reform must address the "too-big-to-fail" problem, which has become even bigger in the financial crisis. The desire to break up large institutions is understandable, but I don't think there is any going back to the era of Glass-Steagall. Taxpayers are providing a substantial benefit to the shareholders and creditors of institutions considered "too-big-to-fail," and these institutions should meet higher standards for safety and soundness. As financial firms grow larger, they should be subject to greater disclosure requirements, required to hold more capital, satisfy stiffer liquidity standards, and pay deposit and other insurance premiums commensurate with their size and the risks they pose. Capital buffers and insurance premiums should increase in the good times and decline in the bad times.

Third, reform should make financial markets more transparent. Opaque structured-finance markets facilitated the origination of trillions of dollars in badly underwritten loans which ignited the panic when those loans and the securities they supported started to go bad.

The key to better functioning financial markets is increased transparency. Requiring over-the-counter derivative trading takes place on central clearing platforms make sense; so does requiring that issuers of structured financed securities provide markets with the information necessary to evaluate the creditworthiness of the loans underlying the securities. Issuers of corporate equity and debt must provide extensive information to investors, but this is not the case for mortgage and asset-backed securities. Having an independent party also vet the data to ensure its accuracy and timeliness would also go a long way to ensure better lending and reestablishing confidence in these markets.

Fourth, reform should establish the Federal Reserve as a systemic risk regulator. The Fed is uniquely suited for this task given its position in the global financial system, its significant financial and intellectual resources, and its history of political independence.

The principal worry in making the Fed the systemic risk regulator is that its conduct of monetary policy may come under onerous oversight. Arguably one of the most important strengths of the financial system is the Fed's independence in setting monetary policy. It would be very counterproductive if regulatory reform were to diminish even the appearance of that independence. To this end it would be helpful if oversight of the Fed's regulatory functions were separated from the oversight of its monetary policy responsibilities. One suggestion would be to establish semi-annual reporting to the Congress on its regulatory activities much like its current reporting to Congress on monetary policy.

Fifth, and finally, reform should establish a new Consumer Financial Protection Agency to protect consumers of financial products. The CFPA should have rulemaking, supervision, and enforcement authority. As is clear from the recent financial crisis, households have limited understanding of their obligations as borrowers or the risks they take as investors.

It is also clear that the current fractured regulatory framework overseeing consumer financial protection is wholly inadequate. Much of the most egregious mortgage lending during the housing bubble earlier in the decade was done by financial firms whose corporate structures were designed specifically to fall between the regulatory cracks. There is no way to end the regulatory arbitrage in the regulatory framework. The framework itself must be fundamentally changed.

The idea of a new agency has come under substantial criticism from financial institutions that fear it will stifle their ability to create new products and raise the cost of existing ones. This is not an unreasonable concern but it can be adequately addressed. The suggestion that the CFPA should require institutions to offer so-called plain vanilla financial products to households should be dropped. Such a requirement would create substantial disincentives for institutions to add useful features in existing products.

Finally, let me just say I think the Administration's proposed regulatory reform is much-needed and reasonably well-designed. Reform will provide a framework that would not have prevented the last crisis, but it would have made it measurably less severe and it certainly will reduce the odds and severity of future calamities.

[The prepared statement of Dr. Zandi can be found on page 112 of the appendix.]

Mr. CLEAVER. Our final witness is John H. Cochrane, AQR capital management professor of finance at the University of Chicago Booth School of business.

STATEMENT OF JOHN H. COCHRANE, AQR CAPITAL MANAGEMENT PROFESSOR OF FINANCE, THE UNIVERSITY OF CHICAGO BOOTH SCHOOL OF BUSINESS

Mr. COCHRANE. Thank you for giving me the opportunity to talk to you today.

This wasn't an isolated event. We are in a cycle of ever-larger risk taking punctuated by ever-larger failures and ever-larger bailouts, and this cycle can't go on. We can't afford it. This crisis strained our government's borrowing ability, there remains the worry of flight from the dollar and government default through inflation. The next and larger crisis will lead to that calamity.

Moreover, the bailout cycle is making the financial system much more fragile. Financial market participants expect what they have seen and what they have been told, that no large institution will be allowed to fail. They are reacting predictably. Banks are becoming bigger, more global, more integrated, more systemic, and more opaque. They want regulators to fear bankruptcy as much as possible.

We need the exact opposite. We and Wall Street need to reconstruct the financial system so as much of it as possible can fail without government help, with pain to the interested parties but not to the system.

There are two competing visions of policy to get to this goal. In the first, large integrated instructions will be allowed to continue and to grow with the implicit or explicit guarantee of government help in the event of trouble, But with the hope that more aggressive supervision will contain the obvious incentive to take more risks.

In the second, we think carefully about the minimal set of activities that can't be allowed to fail and must be guaranteed. Then we commit not to bail out the rest. Private parties have to prepare for their failure. We name, we diagnose, and we fix whatever problems with bankruptcy law caused systemic fears.

Clearly, I think the second approach is much more likely to work. The financial and legal engineering used to avoid regulation and capital controls last time were child's play. "Too-big-to-fail" must become "too-big-to-exist."

A resolution authority offers some advantages in this effort. It allows the government to impose some of the economic effects of failure, shareholders and debt holders lose money, without legal bankruptcy. But alas, nothing comes without a price.

Regulators fear—their main systemic fear is often exactly the counterparties will lose money, so it is not obvious they will use this most important provision and instead bail out the counterparties.

I think the FDIC, as often mentioned, is a useful model. It is useful for its limitations as well as for its rights. These constrain

moral hazard and keep it from becoming a huge piggybank for Wall Street losses.

The FDIC applies only to banks. Resolution authority must come with a similar statement of who is and who is not subject to its authority. Deposit insurance and FDIC resolution come with a serious restriction of activities. An FDIC-insured bank can't run a hedge fund. Protection, resolution, and government resources must similarly be limited to systemic activities and the minimum that has to accompany them.

Deposit insurance in FDIC resolution address a clearly defined systemic problem, bank runs. A resolution authority must also be aimed at a specific defined and understood systemic problem, and the FDIC can only interfere with clear triggers.

The Administration's proposal needs improvement, especially in the last two items. It only requires that the Secretary and the President announce their fear of serious adverse effects. That is an invitation to panic, frantic lobbying, and gamesmanship to make one's failure as costly as possible.

It is useful to step back and ask, what problem is it we are trying to fix anyway? Regulators say they fear the systemic effects of bankruptcy. But what are these?

If you ask exactly what is wrong with bankruptcy, you find fixable, technical problems. The runs on Lehman and Bear Stearns brokerages, collateral stuck in foreign bankruptcy courts, even the run on money market funds, these can all be fixed with changes to legal and accounting rules. And resolution doesn't avoid these questions. Somebody has to decide who gets what. If Citi is too complex for us to figure that out now, how is the poor Secretary of the Treasury going to figure it out at 2 o'clock in the morning on a Sunday night?

The most pervasive argument for systemic effective bankruptcy, I think, is not technical; it is psychological. Markets expected the government to bail everybody out. Lehman's failure made them reconsider whether the government was going to bail out Citigroup. But the right answer to that problem is to limit and clearly define the presumption that everyone will be bailed out—not to expand it and leave it vague.

Here I have to disagree with Mr. Volcker's testimony. He said we should always leave people guessing, but that means people will always be guessing what the government is going to do, leading to panic when it does something else. And let me applaud Chairman Frank's statement earlier that no one will believe us until we let one happen. I look forward to, not necessarily to that day, but to the clearer statement—clearer understanding by markets and the government of what the rules are going to be the day afterwards.

[The prepared statement of Professor Cochrane can be found on page 57 of the appendix.]

Mr. CLEAVER. We are going to begin the conversation with the gentleman from Texas, Mr. Neugebauer, who has an appointment that he needs to keep and so we will begin with him, and then we will move to the other side.

Mr. Neugebauer.

Mr. NEUGEBAUER. I thank the gentleman for accommodating me. One of the things that I hope that we all agree on, and I think I

hear, is that there are no more bailouts. That is bad for market discipline, that companies that make bad decisions have to suffer the consequences of that. And one of the elements of the Republican alternative is that we believe there are ways to do that. One is making sure that entities are adequately capitalized. But secondly, not having someone choose which companies are systemically risky to the marketplace and thereby giving them a free pass on their market activities.

But I want to go to the resolution issue because I think it is probably as equally important in restoring market discipline.

One of the things that I am very concerned about in the current bill is that it is a wheel of fortune, as I call it, when you get to the bankruptcy or to the dissolution of that entity. Because if someone is arbitrarily going to just choose which people get made whole and which aren't and which people get a certain percentage and not follow some orderly discharge of those obligations, how am I going to estimate what my risk is when I am either buying equity or I am buying security or buying debt or I am buying subordinated debt or taking an unsecured position or secured position if somebody else is going to determine what my position is?

So the Republican plan quite honestly has designed about, as I think Mr. Cochrane was talking about, is that if there are—we actually set up a special chapter in the Bankruptcy Code, and if there are special powers or additional expertise that are needed to make that discharge, but that way everybody that is making an investment in an organization knows that if this investment does go south, they understand what their position is and not relying on the wheel of fortune in some cases where if the wheel turns in my direction, I went from an unsecured to a more preferential position.

Your comments, Mr. Cochrane? I will start with you and kind of just go down the line there.

Mr. COCHRANE. Yes. I would agree with you. One thing that worries me about great power and no rules is precisely that means not only is it a wheel of fortune, it is a wheel of fortune that answers your phone calls. So there will be a lot of lobbying.

It also means that the game of buying debt becomes not one of guessing what is the value of the assets, it is one of guessing what am I going to get out of the new resolution authority.

And finally, we are acting as if it is simple. The whole reason we are worried about this is that the web of counterparties which are systemic, which aren't systemic, who should get money, who not, too complicated to think about. Well, goodness gracious, it is going to be even more complicated to think about it at 2 o'clock on a Sunday morning.

Mr. ZANDI. I agree with many of the things that you said. The one thing I worry about and am concerned about is putting these institutions into bankruptcy. That has its own set of uncertainties as any firm going into bankruptcy and creditors know. And the problem is that the uncertainty can drag on for quite some time, because of the nature of these financial institutions. We don't have the time. So I think we need a resolution mechanism that is independent of the bankruptcy system. I don't think the system can be fixed to a sufficient degree to address those issues, and to take our chances in using bankruptcy, of course, for this process would in

fact create greater uncertainty and cost taxpayers more in the long run.

Mr. NEUGEBAUER. As a follow-up to what you are saying, I think what we envision is a separate actually—possibly judicially, have special courts to do that, to have the expertise to make those decisions relatively quickly so that if there is a continuation possibility in that entity that there is the ability for someone to make those decisions at that particular point in time. It is not much different than the resolution concept except that we are going to have an orderly disposition in the event of a liquidation and settling that everybody understands.

Mr. Miron?

Mr. MIRON. I would emphasize two aspects of your comments. One is I personally think there should be no more bailouts. Whatever the resolution system is, whether it is a bankruptcy court, a new kind of bankruptcy that no taxpayer money goes into it.

Then the second point is, can we design a bankruptcy system, even for nonfinancial firms, that is smoother and faster than the current one. The answer is probably, but certainly it might be appealing to try to design something which is very fast and very smooth, say a default off the shelf and last will and testament that you have to create when you are incorporated.

But I also think finally that the risks of the financial firm bankruptcies have been exaggerated. I don't say they were zero by any means, but I think there was a lot of claiming that the sky was going to fall in, which was not based on evidence in the historical records. Particularly before 1914, we had many, many financial panics. The vast majority were not associated with major changes in the economy. They were short. They were limited to a few firms and a few cities and the economy recovered very quickly.

Mr. LEVITT. You know, it is so hard to be formulaic about these issues and to try to define what is in the public mind and what isn't.

When you are going through a panic, and we went through a panic, it is scary, very, very frightening. And I wouldn't take the position that there will be no more bailouts. We don't know what there is going to be or how great the threat is going to be. But if the resolution authority is so established where the onus is put on both creditors and shareholders they will be, in my judgment, in a much better position to evaluate the condition of given institutions than any regulator might be. I think holding their feet to the fire in that fashion will go a long way toward avoiding the kind of calamity that you speak of.

As to the need for a systemic risk overseer in terms of a council that would serve as an early warning system, I think that makes a good deal of sense. It would be a hands-on group that would be led by a presidential employee. As an alternative, if the Fed were to get rid of its conflicts—and I think they have very profound conflicts which make them a less than ideal systemic risk regulator—I think the combination of these two could do a great deal to restore public confidence.

If the public loses total confidence in the system, all of our pronouncements about "too-big-to-fail" and we can't afford the bailout,

or what have you, go up in smoke. It is a power that should not be underestimated.

Mr. CLEAVER. Thank you. We are going to have votes in maybe 15 or 20 minutes. I do think we can get all members in if the members will use the Reader's Digest version of your questions and if you will give the Cliff Notes version of the answer, I think we can get through all of these.

We will begin with the gentlelady from Illinois, Ms. Bean.

Ms. BEAN. Thank you, Mr. Chairman, and to the witnesses for sharing your expertise today.

Many of us have advocated for countercyclical capital requirements to avoid the kind of depth and width of the downfall that we recently experienced, specifically to discourage the type of leverage that we saw. And as Mr. Zandi said in his own testimony, if I understood it properly, suggesting that when we see a bubble in formation, obviously increasing capital requirements will maybe minimize how big that bubble gets. In a precipitous downfall we would ease up capital requirements as well, which we didn't do, so it doesn't get so wide as institutions divest themselves, even in this case non-subprime related assets.

Given that history suggests that regulators, though they have the authority to impose those changes, tend not to want to be the buzzkill when the party is going, will regulators follow guidance from the Feds or does Congress really need to be more proscriptive in that regard and require those type of changes relative to capital requirements?

I am asking Mr. Zandi specifically.

Mr. ZANDI. I think it is a reasonable concern based on historical experience. Regulators don't step in when they need to. It is very difficult to do that. And in tough times, they put more pressure on institutions, and it can be counterproductive.

I don't think it should be resolved legislatively. I think, though, it can be addressed through the various accounting rules that are adopted to try to effectuate a countercyclical effort to raise capital standards, various kinds of insurance. So I think if you can codify it in the accounting rules, I think that would be a more effective way of doing it.

Once you start legislating it, then it becomes so binding that—we don't really know what is going to work well. Part of it is going to be experimentation, and it is hard to change legislation easily. So I think if you can make sure that the accounting rules are set in a way that this is done to your satisfaction, then that would be the more appropriate thing.

Mr. LEVITT. I think that is an important point. Accounting is really at the heart of much of the problem. We don't really know what many of these institutions hold in their portfolios. I really believe that we need fair market accounting on the part of financial institutions, and I think that a lot of this depends upon whether you are a deposit-taking institution that engages in transactions involving risk or whether you are not a deposit-taking institution.

I think fair value accounting conveying a clear picture to investors of precisely what risk they may be taking is terribly important.

Ms. BEAN. Thank you, and I yield back.

Mr. CLEAVER. The gentleman from California, Mr. Sherman.

Mr. SHERMAN. Mr. Levitt, you say we shouldn't adopt the standard of no more bailouts. The Executive Branch believes not only that there should be a capacity for future bailouts but that it ought to be orderly. And by orderly, what they mean is no further congressional involvement, that if the Executive Branch wants to tie up $1 trillion, $2 trillion, and they think it is necessary, God, they are good people, they should be able to make that decision without the disorderliness that we saw last fall where Congress added a bunch of provisions, oversight, and even voted it down the first time.

Do you believe that we ought to give the Executive Branch the authority to commit over $1 trillion to bail out systemically important firms in a time of crisis without further congressional approval?

Mr. LEVITT. I would rather not be specific about that issue because again, it is so difficult to be in the eye of the storm and find yourself bound by formulaic restrictions.

Mr. SHERMAN. Sir, you are an American. Do you believe in the Constitution or not? Is your loyalty to Wall Street greater than your loyalty to the Constitution?

Mr. LEVITT. I don't think anything in my public life would lead anyone to that conclusion, Mr. Sherman.

Mr. SHERMAN. Doesn't the Constitution say that appropriations are supposed to be made by Congress and that Congress doesn't just give the Executive Branch the right to, in some future instance, spend $1 trillion, $2 trillion, $3 trillion of taxpayer money without any congressional involvement? Doesn't it bother you as an American?

Mr. LEVITT. I think Congress is intimately involved and has been intimately involved in this whole process or we wouldn't be sitting here right now.

Mr. SHERMAN. Briefing a few congressional leaders is constitutionally irrelevant. The Constitution calls for votes on the Floor of Congress where even bald guys from California get to vote. For you to say that the principles of the Constitution are achieved because a few congressional leaders are briefed—

Mr. LEVITT. You are putting words in my mouth, Mr. Sherman. That is not what I said.

Mr. SHERMAN. Perhaps you should speak for yourself.

Mr. LEVITT. You are misinterpreting what I have said. And I don't know that this is the appropriate forum to argue about constitutional support or constitutional values.

Of course, I believe in the power of the Congress and the power of the people.

Mr. SHERMAN. Let me move on.

There is an argument that the only way we can have institutions that are "too-big-to-fail" is to have a system for bailing them out if they do fail and of course higher capital requirements in the hope that they won't. The other approach is "too-big-to-fail" is too big to exist.

We could have a rule that said no company can enter into contracts which caused them to be liable to American persons in excess of 1 percent of the U.S. GDP. This could be binding on foreign and domestic firms and so if a firm approached that limit, they

might choose to break up, otherwise they cannot enter into new contracts which obligated them.

Mr. Cochrane, is it better to have a system of larger and larger and larger tier 1 financial institutions where people know that if you are one of the top five you have a 50 percent chance at least of being bailed out if you get into trouble, or is it better to say "too-big-to-fail" is "too-big-to-exist?"

Mr. COCHRANE. "Too-big-to-fail" is "too-big-to-exist."

Mr. SHERMAN. Mr. Zandi?

Mr. ZANDI. I am a little nervous about answering, to tell you the truth, I think given what happened before.

My sense is that in theory it would be nice to say that if you are "too-big-to-fail," you are "too-big-to-exist." But in reality, in practice, that is not going to happen. That won't happen. I don't think it is efficient. Our institutions won't be competitive globally.

Mr. SHERMAN. If we impose on all institutions worldwide the same standard; that is, do not have liabilities to U.S. persons in excess of 1 percent of the U.S. GDP, that would allow all firms, no matter where headquartered, to have the same systemic risk to the U.S. economy.

Mr. ZANDI. Two points. One is, why 1 percent? The second is, we live in a global financial system. We are not an island unto ourselves.

Mr. CLEAVER. Mr. Manzullo, the gentleman from Illinois.

Mr. MANZULLO. Sometimes the hearing that has the fewest members turns out to be one of the most unusual. I always enjoy somebody who teaches at Harvard and is a senior fellow at the Cato Institute. That is interesting. I have big problems with the message that we are going to set up the safety net for your guys who screw up on Wall Street. I mean, that is how I look at this legislation. It has created an America that is looking for a bailout for everything. And people are smart enough to realize that there is no bailout, that the people who are actually either the—probably the water in the buckets are the taxpayers who have to take care of this load.

Why have a piece of legislation, Mr. Miron, that, for example, you say in the very last line on page 3 of your testimony, "thus this bill institutionalizes TARP for bank holding companies." Tell us what is wrong. Just go into depth on your statement.

Mr. MIRON. The crucial thing is that under this bill, it is not just that we have given the FDIC power to resolve, to settle the competing claims, which is similar to what a bankruptcy judge does, but we very explicitly said that the FDIC can borrow money from Treasury—that is explicitly in the bill—can use that money from Treasury to buy the debts of the failing institutions, to take equity stakes, to guarantee its obligations and all sorts of things.

Now, there are provisions in the bill where allegedly the FDIC is going to recoup that money later on. The way it recoups it is truly bizarre. It recoups it by levying fees on all the remaining tier 1 financial institutions. So it is kind of like the deposit insurance system except it is ex post, not ex anti.

So the incentive it sets up is for every one of those firms, take as much risk as you can, sometimes you will make a lot of profit. If you fail and you disappear, then the people who pay for that are

all of the remaining firms in the industry. So of course every firm is going to be thinking that way, so they are all going to be simultaneously trying to outrisk each other. It is just an unmitigated recipe for disaster.

Mr. MANZULLO. There is a new form of capitalism called joint and several liability.

Mr. COCHRANE. It also gives them an incentive to make your failure as systemically fearful as possible, not just to make you get the bailout, but you want to hold a gun to everybody's head that you are as dangerous to the financial system as possible so that you can get the bailout.

Mr. MANZULLO. Does it bother you that institutions beyond financial institutions could be impacted by this legislation?

Mr. MIRON. In what manner?

Mr. MANZULLO. The broad swoop that could bring in a nonbank.

Mr. MIRON. Absolutely. First of all, the definition of what is an institution covered by this ends up being extremely malleable. So GMAC is probably going to come in, and if GMAC is in, then somehow General Motors gets in. You are going to have people who make toaster ovens who buy a small brokerage service firm, put it on their books, and they are covered and they are "too-big-to-fail" and have access to all of these Treasury funds, yes. It is just incredible—it is a blank check.

Mr. MANZULLO. Do you fellows feel that it would have been better if these banks and obviously the car companies had just filed straight Chapter 11 liquidation? Not Chapter 11, Chapter 7 or Chapter 11, that would be reorganization and Chapter 7 is straight bankruptcy. Use regular bankruptcy laws.

Mr. MIRON. Absolutely. Now, people correctly point to the fact that there are all of these counterparty claims that banks have and so if one fails it is likely to spill over into other institutions. That is exactly right, but that is only half the story.

The other half of the story is it happens a few times and all of these banks and nonbank financial institutions are going to start taking on fewer counterparty risks. They are going to start to hedge better, they are going to take less risks, and they are going to start to adjust their behavior so that then the spillovers when one fails will not be nearly as extreme. And it is going to be painful to get to that point where people do business in a different way. But as Chairman Frank said at the very beginning, it is not going to start happening until we actually stick it to somebody.

Mr. LEVITT. I think the resolution authority is more effective than the bankruptcy law in terms of doing the job you want done. It is fairer.

Mr. MIRON. It is fairer?

Mr. CLEAVER. I am going to call on the gentleman from Colorado, Mr. Perlmutter.

Mr. PERLMUTTER. Thank you, Mr. Chairman. Let us sort of get back to that last topic. That is the last thing that I need to understand.

Chairman Levitt, how do we resolve broker-dealers?

Mr. LEVITT. How do we resolve?

Mr. PERLMUTTER. Broker-dealers.

We have a court proceeding through a liquidation. How do we resolve banks and credit unions? Mr. Miron, how do we liquidate banks and credit unions?

Mr. MIRON. The way we liquidate them now in is through the FDIC. In the vast majority of cases until recently—

Mr. PERLMUTTER. We liquidate them. We liquidate them and sell and then we offload whatever are the bad debt and we tried to sell them, parcel them out, do something with them.

Mr. Cochrane, how do we liquidate or how do we resolve insurance companies?

Mr. COCHRANE. The key component—

Mr. PERLMUTTER. How do we resolve insurance companies? Do you know? We liquidate them through the insurance commissioner.

Now, guys, I am a Chapter 11 lawyer. I did it for 25 years. So if the Republicans want to have more Chapter 11, God bless them. I just don't see when you are dealing—when you have assets that are fairly liquid, whether they are stock certificates that you are holding or insurance policies you are holding or cash that you are holding, a Chapter 11 doesn't work very well because now you are dissipating potentially during the course of the reorganization assets that really belong to somebody else.

Now, you know, I have done—I can't tell you how many Chapter 11's I have done. And you can see that by taking GM, Chrysler, they were able to go through Chapter 11, but they did a lot of work proceeding that to do the Chapter 11.

So, in my opinion, if we have a holding company that may—part of the problem is, I think, that we have institutions that are just too big and they also have too many products. They are stockbrokers, they are insurance companies and they are banks, all at the same time. And so now how do we deal with them in an orderly way? Everybody is using resolution authority. I call it something where we need to have an orderly liquidation. Now, do you think we can do that in a Chapter 11, really, Mr. Miron?

Mr. MIRON. Yes. I agree that you are going to end up in many cases just liquidating. In some cases, depending on the nature of the different things that have been put together, some pieces are easily sold off and can operate; some pieces were perfectly solvent and profit-making.

Mr. PERLMUTTER. So how do you manage those really liquid assets that might be a depositor's asset, or it is a bond or it is a stock certificate or something? See, the problem is, we have—

Mr. MIRON. I don't understand why we don't just sell it to the highest bidder. I am confused. Why doesn't it just get sold to the highest bidder?

Mr. PERLMUTTER. Well, that would be a liquidation. That would be a Chapter 7. And I don't mean to—you guys use bankruptcy as if it is some general term. You do things differently in bankruptcy court.

Mr. ZANDI. Can I make a point? We had a case study of a firm that went into bankruptcy, and we saw how well it went. Lehman Brothers is a case in point that went into bankruptcy. It was a complete mess. It would have been a complete fiasco if the government had not stepped in, in response to that.

I think we saw pretty clearly what bankruptcy does. It does not work in the case of these large, very complicated institutions, which have very liquid assets that can go out the door immediately. It just didn't work and I don't think you can fix it to make it work.

Mr. PERLMUTTER. I really would like to think that it could, okay? Now, I guess maybe I have done too many of them to recognize how long some of these things take and how complicated they get and how you fight about a particular subject in the court when these are the kinds of things that require resolution promptly, quickly, for the certainty that you are seeking, Mr. Miron and Mr. Cochran, the certainty that you are seeking for the marketplace?

Mr. LEVITT. Or the certainty that resolution brings to the process by putting the creditors on notice that they, too, can lose everything before it happens.

Mr. PERLMUTTER. Right. See, I don't want any more bailouts. I am with you guys. And I subscribe to the "too-big-to-fail" is "too-big-to-exist." Great. Those are nice goals and platitudes. But when you are in an emergency, you are in an emergency, and all rules seem to go by the wayside because you just have to get the job done and keep the system going. I want to separate stockbrokers from the bankers.

Thank you, Mr. Chairman. I appreciate the time.

Mr. CLEAVER. [presiding] Thank you. Mr. Foster from Illinois.

Mr. FOSTER. Thank you. First, I would like to second my endorsement of Dr. Zandi's endorsement of periodic stress tests for potentially systemically important firms. So, for example, if specifically, all firms that have balance sheets that exceed 1 percent of GDP would be required to report in appropriate detail what their situation would be like under conditions of mild, moderate, or depression-like economic downturn. I think this would be a tremendous benefit. If you have comments on that, I would be interested in hearing them.

The second thing I would be interested in hearing your comments on is the concept of requiring large firms to maintain a living will, essentially a pre-negotiated private sector bailout. A variation of this are these reverse convertible debentures, if I am pronouncing that correctly, where you essentially have things that convert to equity, and requiring firms that are approaching "too-big-to-fail" to hold a significant amount of debt in that form, so that when the trigger gets pulled, they automatically have a pre-negotiated, as I say, private sector bailout.

And I think forcing institutions to confront the possibility of their demise, having the board of directors vote on, yes, this is the plan for dissolving ourselves if we fail, could have a tremendously positive cultural impact on Wall Street. So I would be interested.

And finally, the last question is whether any of you are aware of anything that is understood about the efficiency of our economy as a function of the maximum allowable bank size. Like what is the hit in economic growth that we would take if we limited banks to certain sizes. If there is anything that is known about that academically, I would be very interested in hearing about it.

Mr. ZANDI. Well, let me say I think the idea of requiring institutions to have a living will as part of that process, also engaging in regular stress testing, would be very therapeutic. I think it would

provide a lot of information to the marketplace, and I think it would be very therapeutic for the banks. It was actually surprising to me in the stress tests that were conducted back in the spring that it was such a chore for the institutions; you would think that they would have the mechanism for doing things like this. But in fact, they really did not.

I think just going through that process was very enlightening for them, for the regulators and for, obviously, market participants, and it was very key to turning confidence around at a very important point in the crisis. I think it was very important and therapeutic. So I think that is vital.

That is an interesting question about bank size and economic efficiency. I don't know of any academic literature, but that would be an interesting thing to explore.

Mr. FOSTER. It certainly gets mentioned qualitatively. Every time we talk about limiting bank size, they say, oh no, this would be a disaster for economic efficiency. I would like to see the curve of economic efficiency versus bank size limits.

Mr. COCHRANE. It is a hard question, and I can't tell you the answer, but I can tell you the question. Which is, are banks so large because that is the natural—they are more efficient by being more large, or are banks more large because this gets them better access to bailouts and government protection? I have suspicions it is in the other direction, but I wish I had better evidence.

Mr. FOSTER. Any other comments on this? Then I yield back.

Mr. CLEAVER. Thank you. The gentleman from Texas, Mr. Green, is recognized for 3 minutes.

Mr. GREEN. Thank you, Mr. Chairman. But, Mr. Chairman, out of fairness, I am not sure that this young man has had—

Mr. HIMES. No, no. Go ahead.

Mr. GREEN. Thank you. And I will be as terse and laconic as possible. Permit me to say that I don't have the time to lay the proper predicate, but, Mr. Levitt and Mr. Miron—Mr. Miron, following your logic, we would not use the FDIC for banks. We would use bankruptcy, following your logic.

Now, with that aside, I would like to talk about this issue of pain that you use rather cavalierly. Pain needs to be defined, because pain can mean more than just a loss of money. It can also have something to do with the worth of money.

Mr. Levitt, if you would, the pain of allowing AIG to go into bankruptcy, the pain of allowing Bear Stearns to go into bankruptcy, the pain of allowing Lehman to go into bankruptcy, the pain of allowing the auto industry—Chrysler and GM—to go into bankruptcy, what would that pain translate into locally, meaning within the United States and globally?

Mr. LEVITT. That pain has a danger that reverberates not just throughout the United States, but throughout the world, because what you are talking about is the pain of public confidence. And that loss of public confidence could lead to catastrophic results. So it is very hard to quantify the implications of job loss, of the cratering of institutional creations that were looked upon as symbols of stability, and it just shakes the confidence of the people to its very roots. So that is a very, very severe penalty.

Mr. GREEN. My final comment would be this—and I will yield back. My concern is this; is that we are not paying enough attention to each other. My belief is that we all want a resolution authority, without spending tax dollars. But for some reason, we are saying such that it appears as though the other doesn't want it, when I think the folk on the other side desire it, and the folks on this side desire it.

But I do think that there has to be some credence given to what Mr. Levitt has said. You can never say never in a world that is dynamic. It is not static. I remember Ronald Reagan saying that he would never sign a certain piece of legislation. He said that his feet—he was sealed in cement. And when he signed it, he said what you hear is that cement cracking right now.

My point is, I am with all of you. We should not bail out. Never bail out again as long as we live. Don't want to do it, shouldn't have done it this time. Never. God forbid, if we have to, how do we do it?

Thank you, Mr. Chairman. I yield back.

Mr. CLEAVER. Thank you. One of the questions that plagues me is the whole concept of "too-big-to-fail," which may be also "too-interconnected-to-fail." And I don't know if those are synonymous, "too-big-to-fail" and "too-interconnected-to-fail." How do you read those, Dr. Zandi?

Mr. ZANDI. I think they are synonymous. I think you can be large, and if your connections are limited, and you are not going to affect other institutions, then I think you can be resolved in the normal course of affairs. I don't think that is significant. But generally, I mean, if you are large and big, that means you are interconnected. You can't become large and big unless you are. You have all these different relationships and moving parts and, therefore, big generally is synonymous with—

Mr. CLEAVER. So should we restrict the connectedness?

Mr. ZANDI. I don't think you can.

Mr. CLEAVER. I mean, that prevents the snowball from rolling down the hill.

Mr. ZANDI. I don't think you can, because these institutions need to have relationships all over the globe in different markets, you know; they are providing different kinds of products and services to the economy. So I don't think there is any logical way of doing that, no.

Mr. COCHRANE. I do think, sir, that you are asking an extremely important question that I hope you will ask more and more. Too-what-to-fail? Through last year I have heard lots of oh, there will be—the world will end. There will be systemic risk. And nobody says exactly what is the systemic risk that is going to cause the great calamity. Is it too big? Too interconnected? What exactly is the problem? Keep asking that question, please.

Mr. ZANDI. Well, I could give an answer. Just go back to last September and October. It came to such a point that the—because of the failure of Lehman, because of the near failure of AIG, because of other various events, the Nation's nonfinancial commercial paper market was frozen, literally. So blue chip companies that make everyday products were on the verge of shutting their businesses down. And I know this firsthand, because I was getting calls from

senior management of major retailers saying, “I am not going to get delivery of product to put onto my store shelf because this company can’t get credit.”

So that was because of the interconnectedness of the financial system, and it bled right to the nonfinancial world, literally within a few days.

Mr. COCHRANE. It wasn’t just because of Lehman Brothers failing.

Mr. CLEAVER. Okay. Under normal circumstances I would like to keep going on this, because I am very concerned about it. And if I had time, I would like to juxtapose what the Swedish Government did with what we did. They separated the troubled assets and created—we kind of flirted with this for a moment about the bad bank, which is a bad term. But since we don’t have time, and since I don’t want to miss the vote, I appreciate very much you sharing with us, and your time and your intellect. This has been very, very helpful and informative.

There are some things I am supposed to say. So whatever I don’t say that I am supposed to say, it is said. The committee is adjourned.

[Whereupon, at 12:35 p.m., the hearing was adjourned.]

A P P E N D I X

September 24, 2009

Statement by Rep. Michele Bachmann
House Financial Services Committee Hearing
Experts' Perspectives on Systemic Risk and Resolution Issues

September 24, 2009

Thank you, Mr. Chairman.

After months of debate about how to address "systemically risky" or "too big to fail" institutions, I remain unconvinced that moral hazard and perverse market incentives can be avoided under the Obama Administration's financial regulatory overhaul. In fact, those things are innate in the Administration's plan.

Defining large institutions as "Tier 1 Financial Holding Companies" whose creditors will not truly suffer the consequences of company losses will lead to a future filled with careless market discipline and unlimited taxpayer bailouts. Granting financial regulators what the Administration has called "resolution authority" to wind down these "Tier 1" companies in the event of massive failure will only spur investors and lenders to keep making riskier bets than they would have without the cushion of a government guarantee. Congress needs to remember that our regulatory restructuring does not occur in a vacuum. Our decisions create actions and reactions; they have consequences.

If this scenario sounds familiar, it's because it is. We saw this very phenomenon occur with Fannie Mae and Freddie Mac, both of which grew larger and larger as they bought up toxic mortgage-backed securities that eventually went belly up and caused the taxpayers to fork over $200 billion to bail them out. How can we turn our heads from the historical proof we have in Fannie and Freddie? Haven't we learned our lesson?

The Administration's proposal is a codification of the ad hoc approach to bailouts we've experienced over the past two years. It perpetuates this cycle, shielding creditors from taking even the riskiest of risks. In fact, the President of the Minneapolis Federal Reserve Bank, Gary Stern, has said of the Administration's proposal that "there is nothing in the Treasury proposal designed to put creditors of large, systemically important financial institutions at risk of loss."

At the end of the day, I do not see how we can reconcile this problem of moral hazard which got us into the financial crisis in the first place. At yesterday's Financial Services Committee hearing, Treasury Secretary Geithner's response to this question was that more stringent capital requirements and regulatory supervision will be imposed on "Tier 1" institutions. But I'm concerned that that won't be enough to mitigate the tremendous moral hazard here. And even if it did, I strongly question whether it is really the right approach to fixing our financial system, both in principle and in practice.

I thank the witnesses for being here and look forward to today's discussion.

Thank you, Mr. Chairman, and I yield back the balance of my time.

Testimony of John H. Cochrane

Professor of Finance, University of Chicago Booth School of Business

Before the

United States House of Representatives

Committee on Financial Services

Thursday, September 24 2009

Chairman Frank, Ranking Member Bachus, and members of the committee: I am grateful for the opportunity to talk to you today. My name is John Cochrane, and I am a professor of finance at the University of Chicago Booth School of Business. I am here only in that capacity. I represent no firm, industry, organization, or party.

I salute you for taking on these difficult issues, which are vital to the economic health of our nation.

The big picture.

We are in a cycle of ever larger risk-taking, punctuated by ever larger failures and ever larger bailouts. This cycle cannot go on.

First, we cannot afford it. This crisis strained our government's borrowing ability. There remains worry of a flight from the dollar, and default through inflation. We will probably escape that fate, but the next, bigger crisis may be beyond even our government's prodigious resources. That would be a calamity.

Second, the bailout cycle is making the financial system much more fragile. In a crisis, it is forgivable to stem the tide today and worry about moral hazard tomorrow. But now it is tomorrow, and unless we deal aggressively with moral hazard, the next tide will be a tsunami.

Financial market participants expect what they have seen and been told: no large institution will be allowed to fail. They are reacting predictably. Banks are becoming bigger, more global, more integrated, more "systemic," more "interconnected" and more opaque. They want regulators to fear bankruptcy as much as possible, and they will succeed. These actions will make the system less stable, not more so.

We need the exact opposite. We need Wall Street to reconstruct the financial system so that as much of it as possible can fail, with pain to the interested parties, but not to the system. Our task is to write the rules so they do it.

Policy

There are two competing visions of policy to achieve this goal. In the first, large integrated financial institutions will be allowed to continue pretty much as they are, with the implicit or explicit guarantee that they will not fail, but with the hope that higher capital standards and more aggressive supervision will contain their risks and forestall failure.

In the second, we think carefully about the minimal set of activities that cannot be allowed to fail and must be guaranteed. We commit *not* to bail out the rest. Private parties need to prepare for their failure, and monintor and discipline their counterparties to avoid it. We fix, where possible, whatever problems with bankruptcy law cause regulators to fear it.

I think the second approach is more likely to work. The financial and legal engineering used to avoid regulation and capital controls last time were child's play.

Powerful authority is attractive ex-post to mop up. Alas, it sets up incentives which makes the system more fragile in the first place.

Too large to fail must become too large to exist.

Resolution authority.

The issue of a "resolution authority" is on your minds so let me make a few comments.

A "resolution authority" offers some advantages. Currently regulators feel they must bail out creditors to keep them from exercising their claims in bankruptcy court. A resolution authority allows the government to impose some of the economic effects of failure -- shareholders lose their equity, debt holders lose value and become the new equity holders -- without actual bankruptcy.

However, nothing comes without a price. First, much of the "systemic effect" regulators seem to fear is *exactly* that counterparties will lose money, or that subsidiary contractual claims (such as CDS contracts) will be triggered. So, it's not obvious that regulators will use this most important provision. Second, the reason people buy debt in the first place is that they know they can seize assets in the event of default. If the authority is tough with creditors, firms will substitute to short term debt and other "runnable" liabilities, making the system less stable.

The FDIC is a useful model, for its *limitations* as well as the *rights.* A successful resolution authority, which does not just morph into a huge piggybank for Wall Street losses, needs similar strong and clear limitations.

- The FDIC applies only to banks. We know who they are – and that the FDIC cannot "resolve" anything else.

A "resolution authority" must come with a similar clear-cut statement of who is subject to its authority – and most importantly who is not, and therefore *must be allowed to fail*, yes, we really mean it this time! If, as in the Administration's proposal, resolution authority applies to bank holding companies, we must all clearly understand that does *not* mean investment banks, hedge funds, insurance companies, and automobile manufacturers -- and no last-minute change of legal status either, please.

- Deposit insurance and FDIC resolution comes with serious restriction of activities. An FDIC insured bank can't run an internal hedge fund.

Institutions, or parts of them, that are eligible for "resolution" and consequent government resources must be limited to their "systemic" activities as much as possible.

- Deposit insurance and FDIC resolution address a clearly defined "systemic" problem.

Bank deposits are prone to runs, because they have a fixed value (unlike, say, mutual fund shares), and they are redeemed on a first-come first-served basis. Deposit insurance stops runs but puts the government at risk. FDIC supervision and resolution is the sensible covenant of the most senior debt-holder.

A "resolution authority" must similarly be clearly aimed at specific, defined, and understood "systemic" problems.

In the Administration's proposal, the *legality* of a systemic determination is admirably clear, but not the *grounds*. All the Secretary and President have to do is announce their opinion that "the failure of the bank holding company would have serious adverse effects on financial stability or economic conditions in the United States." This is an invitation to panic, frantic lobbying, and gamesmanship to make one's failure as costly as possible.

Of course, this obscurity is not a new problem. As an ardent observer of events in the last tumultuous year, I have heard many declarations of imminent systemic risk, but never any clear explanations.

Fix bankruptcy

This last point is the most important. Before designing a regulatory regime, we have to ask, *what problem is it that we are trying to fix, anyway?* Once stated, what is the best way to fix this problem?

Regulators fear "systemic" effects of bankruptcy, but if you ask what they are, you typically find technical problems that are readily solved. Some examples:

- Lehman and Bear Stearns both experienced runs on their brokerage businesses. If you own stocks in a brokerage account, there is no more reason you should have to go to bankruptcy court to get them – or pull them out in a panic ahead of time -- than you should need to go to court to get your car out of the repair shop if the auto dealer fails. Putting a "ring fence" around brokerage accounts in bankruptcy, or otherwise separating "systemic" brokerage from risk-taking, solves this problem, removing the incentive to run.

- Many investors found collateral tied up in foreign bankruptcy courts. Others, knowing this problem, "ran," refusing to renew short term debt even against good collateral. This is easy to fix. Collateral is collateral, it's yours if the other side defaults!

- Money market funds holding Lehman debt suffered a run, since they promise steady $1 value. There is no reason money market funds can't seamlessly trade at net asset value any time the value falls below $1, removing entirely the incentive to run. Money market funds are not mom-and-pop bank accounts.

In fact, one healthy effect of Lehman's failure is that financial market participants are already addressing these problems, demanding greater soundness of prime-broker relationships, clearer treatment of collateral, and rewriting money-market fund accounting rules. I don't mean to make light of the substantial legal problems. But fixing them will cost a lot less than the hundreds of billions of dollars we are throwing around in bailouts.

Perhaps then the fear is that losses in bankruptcy will lead to the failure of other "systemic" institutions down the chain. But losses in credit markets are small compared to the losses that the financial system absorbs easily in stock markets every day. In any case, the right answer is to protect the systemically important activity downstream, not to bail out losers to restore the appearance of solvency.

Why then is Lehman's failure perceived to be such a problem? The major complaint, and the only persuasive argument, is psychological, not technical: Markets expected the government to bail everybody out. Lehaman's failure made them reconsider whether the government would bail out Citigroup. If everyone expects the government to bail out, it has to do so to avoid a panic.

Needless to say, the right answer to this problem is to limit and clearly define, rather than expand and leave vague, the presumption that everyone will be bailed out.

Bottom line

The major systemic problem last fall was the freezing of short-term debt markets. There are many classic remedies to this problem, including limits on how much systemic activity can be supported by rolling over short-term debt, (the FDIC won't let a bank finance a loan portfolio with overnight debt!) intervention by the Fed as lender of last resort, and removing uncertainty about government action.

We should focus on this question. A broad guarantee that no financial institution can fail is not the answer.

Prepared statement of

Arthur Levitt, former Chairman, Securities and Exchange Commission

Before the House Committee on Financial Services

September 24, 2009

Thank you, Chairman Frank for the opportunity to appear before the Committee to discuss the critical issues of establishing a systemic risk regulator and a resolution authority.

As a former chairman of the Securities and Exchange Commission, and currently as an advisor to Getco Llc, The Carlyle Group, and Goldman Sachs, I hope I can share with you important considerations and perspectives to inform your efforts.

I want to begin by thanking you for your attention to these issues, as the need for regulatory reform is as great as it was even during the worst days of the recent financial crisis. Though the appetite for regulatory reform seems to move in inverse relationship to market performance, the financial markets are no less risky and regulatory gaps remain. I am concerned that public investors may well be convinced, because of the relative market calm of the last few months, that all is well in our regulatory system. But all is not well. And I am glad you are showing leadership in addressing these issues.

Your success will be determined by how well you affirm the principles of effective financial regulation -- principles relating to transparency and regulatory independence, the proper oversight of leverage and risk-taking, the nurturing of strong enforcement, early intervention, and the imposition of market discipline.

One of the key questions before this committee is how to authorize and hold accountable a systemic risk regulator – and who should provide this function.

I would like to suggest that the more critical question is whether any regulator or groups of regulators can have the same impact as well as a resolution authority created explicitly to impose discipline on those with the most power to influence the level of risk-taking: the holders of both equity and debt.

And so in my view, the discussion over the proper authority to oversee and regulate systemic risk, while critical, is secondary to the powers given to a resolution authority to impose discipline through the process of sending failing institutions to their demise. To give a simple

analogy, it does not matter who serves as the cop on the beat if there are no courts of law to send lawbreakers to jail.

So with my time today, I would like to only briefly discuss my preferences regarding who should serve as the systemic risk regulator, and focus more squarely on the matter of a resolution authority.

What is the right structure for a systemic risk regulator?

I believe strongly that a systemic risk regulator must serve as an early warning system, drawing on a broad array of sources of information, and with the power to direct appropriate regulatory agencies to implement actions. I am not opposed to this function and am agnostic about who should lead such an agency and perform this function.

I would caution against making the Federal Reserve the systemic risk regulator in its present structure. The Fed has too many conflicts to do this job effectively. Defending the "safety and soundness" of financial institutions and managing monetary policy creates inevitable and compromising conflicts with the kind of vigilant and independent oversight a systemic risk regulator requires. If, however, the Fed is deemed to be the best available place for this role, I would urge the Congress to remove from the Fed some of its responsibilities – especially those of bank oversight. Let the Fed, and every other regulatory agency, focus on one major responsibility.

Why we need a resolution authority, and what that entails

In many respects, the surest way to cause investors, lenders, and management to focus on risk is not to warn them about risk, but to give them every conceivable way to discover risk and tell them what will happen if they don't pay attention. Right now, because of the permissive policies summarized by the phrase "too big to fail," market participants lack that guidance and foreknowledge, and assume that any institution of a certain size simply won't be allowed to fail. This is a dangerous and costly assumption, and only encourages more recklessness.

Some have suggested that the solution to this problem is to cap the size of any financial institution at some arbitrary amount of asset size. But the nature of today's financial markets makes it impossible to restrict any institution from becoming too big – any nation which sets a cap on the size of its financial institutions will merely see its banks become subordinate to those from other nations. Therefore if you want to address the challenge of "too big to fail", you must address not the "too big" part but the "fail" part – how to manage the process of failure. The problem we have had isn't that institutions were too big – it was that there was no uniform way to let them fail without causing an absolute market meltdown.

In the case of Lehman, the Fed and the Treasury were faced with a choice none of us would want to face – and a choice none of us want to ever face again.

We can deal with this by establishing a resolution authority charged with closing out failed institutions without further government bailouts. Those holding debt and equities in a failing institution would be losers in this process, and the resolution authority would have vast powers to break up institutions which pose system-wide risk. Mandatory conversion would always be on the table, and not all creditors would be treated equally.

A resolution authority which has the power to do just about anything to put a failing bank in order or close it down in an orderly way without a government bailout – such as terminate contracts, sell assets, cancel debt, cancel equity, and refer management for civil penalties for taking excessive risk even after multiple warnings -- would bring a clarifying force to the daily decisions of management, customers, creditors, and investors.

I would expect that they would become a good deal more careful – having foreknowledge of their potential rights and responsibilities should the resolution authority be activated. By having more of a personal stake in potential failure, they would see the advantage to developing more knowledge of individual institutions, and this market discovery may well do the work of many outside systemic risk regulators.

The need for transparency

Of course, if your goal is to incentivize market discovery, you will also want to give market participants greater access to information about the institutions in which they invest. This calls for a greater focus on transparency, which members of this Committee will not be surprised to know I feel has been de-emphasized in recent years. Events of the past year call for every regulatory action to be held to a higher standard of transparency and accountability.

In fact, I would argue that in addition to the creation of a resolution authority, greater transparency is essential to effective systemic risk regulation – whether through the actions of investors or of regulators.

I want to emphasize in particular the importance of fair value accounting for major financial institutions engaging in significant amounts of risk-taking and leverage. Such accounting gives investors a true sense of the value of an asset in all market conditions – not just those conditions favored by asset holders. It is my view that a more vigorous application of fair-value standards would have helped identify some of the major causes of the market bubble that we recently witnessed -- weak underwriting standards, unsound risk management practices,

increasingly complex and opaque financial products, and consequent excessive leverage. Vigorous use of fair-value standards might not have identified all these emerging problems, but with enough transparency and an investor public incentivized to discover these problems before they blew up, I believe we would not have had the system-wide crises we did.

Clearly, a series of other rules – banning the use of off-balance-sheet vehicles, to name just one – would move more information about major financial institutions into the public sphere, making it possible for market participants to price risk appropriately and for a systemic risk regulator to demand fresh infusions of liquidity or higher margin requirements if needed.

I would much prefer that a systemic risk regulator be so effective that a resolution authority would be unnecessary. But sadly, we know that always preventing failure is impossible. It is therefore your job to make failure possible.

I want to thank you again for your attention to these critical issues, and urge you to accelerate your efforts.

Resolving Non-Bank Financial Institutions

Testimony Before the House Financial Services Committee, 9/24/2009

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Chairman Frank, Ranking Member Bachus, and Committee Members:

Let me begin by expressing my thanks for the opportunity to present my views on the matter before this committee.

The question I will address in my testimony is whether Congress should adopt Title XII of the proposed Resolution Authority for Large, Interconnected Financial Companies Act of 2009. This Act would grant the Federal Deposit Insurance Corporation (FDIC) powers for resolving insolvent non-bank financial institutions similar to those the FDIC currently possesses for resolving banks. My answer to the question is an emphatic and unequivocal "No." Let me explain.

The fundamental problem that resolution systems attempt to address is that when a financial or other institution fails, the value of the claims on that institution's assets exceed the value of the assets themselves. Thus, someone must decide who gets what, and it is impossible – by virtue of the assumption that we are dealing with a failed institution – to make everyone whole. The size of the pie owned by the failing institution has shrunk, so those who were expecting a slice of that pie face, collectively, the necessity of going somewhat or substantially hungry. The resolution authority decides who gets moderately well-fed and who starves, but the unchangeable reality is that someone goes wanting.

It is in society's broad interests to have clear, simple, and enforceable procedures for resolving failed institutions, principally to insure that investors are willing to commit their funds in the first place. If the rules about resolution were arbitrary or ever-changing, investors would be loath to invest, and economic investment, productivity, and growth would be greatly reduced. A well-functioning resolution process is part of a good system for

defining and enforcing property rights, which economists broadly agree is essential to a smoothly functioning, capitalist system.

The crucial thing to remember here is that someone has to lose. Just as importantly, it is actually valuable to society as a whole, although not to the directly harmed parties, that those who invested in the failed institutions suffer economic losses. This process releases resources to better uses, it provides signals to the economy about what are good and bad investments, and it rewards those who made smart economic decisions rather than less adept ones. When an economic activity has not turned out well, denying this simple reality makes matters worse.

The flip side of the fact that standard resolution systems, like bankruptcy, impose an institution's losses on that institution's stakeholders, is the fact that a standard resolution authority – such as a federal court – puts none of its own resources into the failed institution, nor does it ever own the failed institution's assets, or make it loans, or anything like that. The resolution authority is resolving claims and dividing the pie; it is not adding more pie that it has taken from somewhere else.

Under the powers that would be granted to the FDIC under the bill being considered, however, the FDIC would have the power to make loans to the failed institution, to purchase its debt obligations and other assets, to assume or guarantee this institution's obligations, to acquire equity interests, to take liens, and so on. This means the FDIC would be putting its own – that is to say, the taxpayers's – skin in the game, a radical departure from standard bankruptcy, and an approach that mimics closely the actions the U.S. Treasury took under TARP. Thus, this bill institutionalizes TARP for bank holding companies.

A crucial implication of this departure from standard bankruptcy is that taxpayer funds foot the bill for the loans, asset purchases, guarantees, and other kinds of financial support that FDIC would provide to prevent failing institutions from going under. These infusions of taxpayer funds come with little meaningful accountability; it will be impossible to know that they have been paid back, and often that will not occur. The proposed new authority for FDIC also generates the impression that society can avoid the losses that failures imply, but that is false: the proposed FDIC actions would merely shift those losses to taxpayers. The new approach is institutionalized bailouts, plain and simple.

Thus, under the expansion of FDIC resolution authority to cover non-bank financial institutions, bank holding companies would forever more regard themselves as explicitly, not just implicitly, backstopped by the full faith and credit of the U.S. Treasury. That is moral hazard in the extreme, and it will be disastrous for keeping a lid on inappropriate risk-taking by these institutions.

Now, a possible response to my concerns might be that the FDIC is already the resolution authority for banks, which makes sense given its role in insuring deposits, so extending this authority to include bank holding companies might seem to be a logical step. In particular, many have argued that under current law, the FDIC does not have the authority to resolve the banks owned by bank holding companies, which leaves it in limbo with respect to insured deposits at those institutions.

This legal grey area is a potential concern, but the right response is to modify that aspect – and only that aspect – of existing FDIC authority, not to grant it the vastly expanded powers under the proposed bill.

This technicality aside, then, the right alternative to expanding FDIC authority – that is, to the bailout approach – is good old-fashioned bankruptcy. It has become "accepted wisdom" that bankruptcies by financial institutions cause great harm, and it is asserted in particular that letting Lehman Brothers fail last September was the crucial misstep that caused the financial crisis. In fact, nothing could be further from the truth.

As I explain in more detail in my written testimony – a paper recently published in the Cato Journal – the ultimate causes of the financial crisis were two misguided federal policies, namely, the enormous subsidies and pressures provided for mortgage lending to non-credit-worthy borrowers, and the implicit guarantees provided by both Federal Reserve actions and the U.S. history of protecting financial institution creditors. These forces generated an enormous misallocation of investment capital away from plant and equipment toward housing, created a housing price bubble, and established a setting where numerous financial institutions were inevitably going to fail because their main assets – the ones backed by housing – were highly overvalued relative to economic fundamentals. Lehman's failure was one part of the adjustment this situation implied, and a necessary part. If anything, too few financial institutions have failed or shrunk, since the massive interventions in credit and housing markets that have occurred over the past year have artificially propped up housing prices, delaying more inevitable adjustments.

Thus the better way to resolve non-bank financial institutions is bankruptcy, not bailout. This is not to say that existing bankruptcy law is perfect; one can imagine ways it might be faster and more transparent, which would probably be beneficial. Nor should one assume that, had bankruptcy been allowed to operate fully in the Fall of 2008, the economy would have escaped without some degree of panic and recession. A significant economic

downturn, in particular, was both inevitable and necessary given the fundamental misallocation of capital that had occurred in the years preceding the panic. But nothing in historical data or recent experience suggests these bankruptcies would have caused anything worse than what we have experienced, and broader bankruptcy would have meant that in future both banks and non-banks would recognize that the losses from excessive risk-taking must be borne by those who take these risks.

In light of these assessments, I urge the members of this committee to vote against this bill, since it codifies an approach to resolution that is fundamentally misguided. We need to learn from our mistakes and trust bankruptcies, not bailout, going forward, as we should have done in the recent past.

Thank you for your time and attention.

BAILOUT OR BANKRUPTCY?

A LIBERTARIAN PERSPECTIVE ON THE FINANCIAL CRISIS

Jeffrey A. Miron

At the end of September 2007, the U.S. economy had experienced 24 consecutive quarters of positive GDP growth, at an average annual rate of 2.73 percent. The S&P 500 Index stood at roughly 1,500, having rebounded over 600 points from its low point in 2003. Unemployment was below 5 percent, and inflation was low and stable.

Roughly 12 months later, in September 2008, U.S. Treasury Secretary Henry Paulson announced a major new intervention in the U.S. economy. Under the bailout plan, as explained at the time, the Treasury proposed holding reverse auctions in which it would buy the troubled assets of domestic financial institutions.[1] Further, as the plan developed, Treasury proposed using taxpayer funds to purchase equity positions in the country's largest banks. These policies aimed to stabilize financial markets, avoid bank failures, and prevent a credit freeze (see Paulson 2008).

In the weeks and months after Paulson announced the bailout, enormous changes occurred in the U.S. economy and in the global financial system. Stock prices fell sharply, housing prices continued the decline they had begun in late 2006, and the real economy

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Cato Journal, Vol. 29, No. 1 (Winter 2009).
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[1] I use the terms financial institution and bank interchangeably to include both banks and investment banks. The distinction became irrelevant on September 22, 2008, when the last major investment banks (Goldman Sachs and Morgan Stanley) became traditional banking institutions.

contracted markedly. The House of Representatives initially voted down the bailout bill, but Congress approved an expanded version less than a week later. The Federal Reserve and other central banks pursued a range of rescue efforts, including interest rate cuts, expansions of deposit insurance, and the purchase of equity positions in banks.

In this article, I provide a preliminary assessment of the causes of the financial crisis and of the most dramatic aspect of the government's response—the Treasury bailout of Wall Street banks. My overall conclusion is that, instead of bailing out banks, U.S. policymakers should have allowed the standard process of bankruptcy to operate.[2] This approach would not have avoided all costs of the crisis, but it would plausibly have moderated those costs relative to a bailout. Even more, the bankruptcy approach would have reduced rather than enhanced the likelihood of future crises. Going forward, U.S. policymakers should abandon the goal of expanded homeownership. Redistribution, if desirable, should take the form of cash transfers rather than interventions in the mortgage market. Even more, the U.S. should stop bailing out private risk takers to avoid creating moral hazards.

The article proceeds as follows. First, I characterize the behavior of the U.S. economy over the past several years. Next, I consider which government polices, private actions, and outside events were responsible for the crisis. Finally, I examine the bailout plan that the U.S. Treasury adopted in response to the crisis.

[2] To simplify the discussion, I use the term bankruptcy to indicate any official reorganization or liquidation procedure, meaning both those under the bankruptcy code and those conducted by regulatory bodies such as the FDIC. The former applies to nonbanks, the latter to banks.

What Happened?

I begin by examining the recent behavior of the U.S. economy. This sets the stage for interpretation of both the financial crisis and the bailout.

Figure 1 shows the level of real GDP over the past five years.[3] GDP increased consistently and strongly until the end of 2006, and then again during the middle of 2007. GDP fell in the final quarter of 2007, rose modestly during the first half of 2008, and then declined again in the third quarter of 2008. Thus, GDP grew on average over the first three quarters of 2008, but at a rate considerably below the post-war average (1.05 percent vs. 3.27 percent at an annual rate).

Figures 2–4 present data on industrial production, real retail sales, and employment. For industrial production, growth was robust for several years but flattened in the second half of 2007 and turned negative by the second quarter of 2008. A similar pattern holds for retail sales, except that the flattening occurred in the final quarter of 2007 and negative growth began in December 2007. For employment, the flattening also occurred in the final quarter of 2007 and negative growth began in December 2007.

The overall picture is thus consistent across indicators. A significant slowdown in the U.S. economy began in the final quarter of 2007 and accelerated during early 2008. This performance is consistent with the determination by the National Bureau of Economic

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[3] The data on GDP (GDPC1), industrial production (INDPRO), real retail sales (RRSFS), employment (USPRIV), residential investment (PRFIC1), the CPI (CPIAUCSL), and the federal funds rate (FEDFUNDS) are from the St. Louis Federal Reserve data bank, http://research.stlouisfed.org/fred2/. The Case-Shiller housing price data are from Standard and Poor's, http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/0,0,0,0,0,0,0,0,0,1,1,0,0,0,0,0.html. The data on homeownership are from the U.S. Census, http://www.census.gov/hhes/www/housing/hvs/historic/index.html. The data on stock prices are from Shiller (2000), updated at http://www.irrationalexuberance.com/.

Research's Business Cycle Dating Committee that a recession began in December 2007 (see www.nber.org/cycles/dec2008.html).

Figure 5 shows the Case-Shiller Housing Price Index, adjusted for inflation, for the period 1987–2008. Housing prices increased enormously over 1997–2005, especially in 2004 and 2005. The increase was large, roughly 80–90 percent in real terms. From the end of 2005, housing prices declined slowly through early 2007 and then at an accelerating pace from that point. Despite these declines, housing still appeared to be overvalued in late 2008 and needed to fall another 20–30 percent to reach the pre-2001 level.

Figure 6 shows the U.S. homeownership rate for the past four decades. After fluctuating in the 63–66 percent range for about three decades, homeownership began increasing in the mid 1990s and climbed to unprecedented values in the subsequent decade. Beginning in 2005 the rate stabilized and declined slightly, but in 2008 it was still well above the level observed for most of the sample.

Figure 7 displays residential investment in the United States over the past several decades. Housing construction fluctuated substantially but displayed an overall upward trend through the early 1990s. From that point the trend accelerated and continued for over a decade before beginning a marked decline starting in early 2006. Even after the substantial decline, however, housing investment in late 2008 was about where one would have predicted based on the trend line through the mid-1990s.

For 10–12 years, therefore, the U.S. economy invested in housing at a rate above that suggested by historical trends. This boom coincided with a substantial increase in homeownership. These facts suggest that the United States overinvested in housing during this period. Housing prices rose substantially over the same period. The fact that housing

quantity and price increased together suggests that higher demand for housing was a major determinant of the housing boom.

Figure 8 shows the real value of the S&P 500 stock price index over the past 150 years. This value soared during the 1990s to a level above that implied by historical rates of return, and growth after 9/11 and the 2001 recession was robust. Even after the large declines in the fall of 2008, therefore, the market was not obviously below a reasonable estimate of its long-term trend. Standard predictors of stock prices, such as the price-earnings ratio, tell the same story.[4]

Figure 9 shows the effective federal funds rate, a standard measure of the stance of monetary policy. The low rate from the early 2000s through much of 2004 was plausibly one factor in the housing and stock market booms. Inflation was low and stable during this period, averaging 2–3 percent for the most part, so the real interest rate was negative. This implies that the demand for stocks and housing should have expanded, driving up their prices. The substantial increase in interest rates from mid-2004 through mid-2006 is plausibly one factor that slowed the economy starting in 2007.[5]

To summarize, the U.S. economy had overinvested in housing as of early 2006, and housing and stock prices were high relative to historical norms. Thus, the economy was misaligned, and a major adjustment—such as a recession—was plausibly necessary to correct the misallocation. The subsequent declines in housing and stock prices (along with the increase in oil prices) reduced the economy's real wealth, providing one impetus for a

[4] For further examination of this issue, see Cochrane (2008) and Hamilton (2008).

[5] An additional cause of low real interest rates may have been a surge in the demand for U.S. assets (a savings glut) caused by global financial imbalances. See Caballero, Fahri, and Gourinchas (2008).

slowdown. Monetary policy stimulated during much of the boom and contracted in advance of the slowdown.[6]

What Caused the Economic Events of the Past Five Years?

Policymakers, pundits, and academics have blamed the financial crisis on various factors, such as excessive risk taking by the private sector, inadequate or inappropriate regulation, deficient rating agencies, and so on. My assessment is that all these factors played a role, but the crucial, underlying problem was misguided federal policies.[7]

The first misguided policy was the attempt to increase homeownership, a goal the federal government has pursued for decades. A (partial) list of policies designed to increase homeownership includes the Federal Housing Administration, the Federal Home Loan Banks, Fannie Mae, Freddie Mac, the Community Reinvestment Act, the deductibility of mortgage interest, the homestead exclusion in the personal bankruptcy code, the tax-favored treatment of capital gains on housing, the HOPE for Homeowners Act, and, most recently, the Emergency Economic Stabilization Act (the bailout bill).[8]

Government efforts to increase homeownership are problematic. Private entrepreneurs have adequate incentives to build and sell houses, just as individuals and families have adequate incentives to purchase them. Thus, government intervention to

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[6] See Mulligan and Threinen (2008) for a more detailed analysis of the role of wealth effects in the propogation of the financial crisis.

[7] For analyses similar to that presented here, see Dorn (2008) and Taylor (2009). For alternative views about the causes of the crisis, see Baily, Litan, and Johnson (2008), Brunnermeier (2008) and Hall and Woodward (2008).

[8] See Slivinski (2008) for further discussion of the government role in promoting homeownership.

expand homeownership has no justification from an efficiency perspective and is instead an indirect method of redistributing income. If government redistributes by intervening in the mortgage market, however, it creates the potential for large distortions of private behavior.

The U.S. government's pro-housing policies did not have noticeable negative effects for decades. The reason is likely that the interventions mainly substituted for activities the private sector would have undertaken anyway, such as providing a secondary market in mortgages.

Over time, however, these mild interventions began to focus on increased homeownership for low-income households. In the 1990s, the Department of Housing and Urban Development ramped up pressure on lenders to support affordable housing. In 2003, accounting scandals at Fannie and Freddie allowed key members of Congress to pressure these institutions into substantial risky mortgage lending.[9] By 2003–04, therefore, federal policies were generating strong incentives to extend mortgages to borrowers with poor credit characteristics. Financial institutions responded and created huge quantities of assets based on risky mortgage debt.

This expansion of risky credit was especially problematic because of the second misguided federal policy, the long-standing practice of bailing out failures from private risk-taking. As documented by Laeven and Valencia (2008), bailouts have occurred often and widely, especially in the banking sector. In the context of the recent financial crisis, a crucial example is the now infamous "Greenspan put," the Fed's practice under Greenspan of lowering interest rates in response to financial disruptions in the hope that expanded liquidity would prevent or moderate a crash in asset prices. In the early 2000s, in particular, the Fed

[9] See Roberts (2008), Leibowitz (2008), Wallison and Calomiris (2008), White (2008), and Pinto (2008).

appeared to have made a conscious decision not to burst the housing bubble and instead "fix things" if a crash occurred.

The banking sector's history of receiving bailouts meant that financial markets could reasonably have expected the government to cushion any losses from a crash in risky mortgage debt.[10] Since government was also exerting pressure to expand this debt, and since it was profitable to do so, the financial sector had every reason to play along.[11] It was inevitable, however, that at some point a crash would ensue. As explained in Gorton (2007), the expansion of mortgage credit made sense only so long as housing prices kept increasing, but this could not last forever. Once housing prices began to decline, the market had no option but to suffer the unwinding of the positions built on untenable assumptions about housing prices.

This interpretation of the financial crisis therefore puts primary blame on federal policy rather than on Wall Street greed, inadequate regulation, failures of rating agencies, or securitization. These other forces played important roles, but it is implausible that any or all would have produced anything like the recent financial crisis had it not been for the two misguided federal polices.[12] Wall Street greed, for example, certainly contributed to the situation if, by greed, one means profit-seeking behavior. Many on Wall Street knew or

[10] Gerardi et al. (2008) find that analysts in the mortgage market realized that a fall in housing prices would mean a drastic fall in the value of mortgage assets, but assigned only a low probability to that outcome. One interpretation is that the analysts (and their employers) trusted the Greenspan put to keep prices from falling.

[11] A mandate that banks issue risky debt might not generate significant problems if the risk is appropriately priced (Stock 2008). When government mandates that banks issue debt they would not have provided on their own, however, a market-clearing price might not exist. An implicit government guarantee of this debt, moreover, virtually ensures the risk will be underpriced.

[12] See Kashyap, Rajan, and Stein (2008) or Calomiris (2008) for a discussion of the regulatory issues and Lucchetti and Ng (2007) for a discussion of the role of ratings agencies.

suspected that their risk exposure was not sustainable, but their positions were profitable at the time. Further, markets work well when private actors respond to profit opportunities, unless these reflect perverse incentives created by government. The way to avoid future crises, therefore, is for governments to abandon policies that generate such incentives.

Was the Treasury Bailout Good Policy?

The Treasury's bailout plan was an attempt to improve bank balance sheets and thereby spur bank lending. The justification offered was that, as of early September 2008, major banks were facing imminent failure because their mortgage-backed assets had declined rapidly in value.

No one disputes that several banks were in danger of failing, but this does not justify a bailout. Failure is an essential aspect of capitalism. It provides information about good and bad investments, and it releases resources from bad projects to more productive ones. As noted earlier, housing prices and housing construction were too high at the end of 2005. This condition implied a deterioration in bank balance sheets and a retrenchment in the banking sector, so some amount of failure was both inevitable and appropriate.

Thus, an economic case for the bailout needed to show that failure by some banks would harm the economy *beyond* what was unavoidable due to the fall in housing prices. The usual argument is that failure by one bank forces other banks to fail, generating a credit freeze. That outcome is possible, but it does not mean the Treasury's bailout plan was the right policy.

To see why, note first that allowing banks to fail does not mean the government plays no role. Federal deposit insurance would prevent losses by insured depositors, thus limiting the incentive for bank runs. Federal courts and regulatory agencies (such as the FDIC) would supervise bankruptcy proceedings for failed institutions. Under bankruptcy, moreover, the activities of failing banks do not necessarily disappear. Some continue during bankruptcy, and some resume after sale of a failed institution or its assets to a healthier bank. In other cases, merger in advance of failure avoids bankruptcy entirely. Private shareholders and bondholders take the losses required to make these mergers and sales attractive to the acquiring parties. Taxpayer funds go only to insured depositors (see Fama 2009, Zingales 2008).

Consider, therefore, how bailout compares to bankruptcy from three perspectives: the impact on the distribution of wealth, the impact on economic efficiency, and the impact on the length and depth of the financial crisis.

From a distributional perspective, bailout is unambiguously perverse; it transfers resources from the general taxpayer to well-off economic actors who profited from risky investments. This is not a criticism of risk-taking; that is appropriate so long as those benefiting in good times bear the costs in bad times. This is exactly what occurs under the bankruptcy approach.

From an economic efficiency perspective, bailout is again problematic. Mere consideration of a bailout distracts attention from the fact that government was the single most important cause of the crisis. Relatedly, bailout creates a moral hazard, thereby generating excessive risk-taking in the future. Bailouts often adopt goals that are not economically sensible, such as propping up housing prices, limiting mortgage defaults, or

preventing the failure of insolvent institutions. More broadly, a bailout encourages perverse actions by institutions that are eligible for the money, such as acquiring toxic assets that the Treasury might buy or taking huge risks with Treasury capital injections.

The Treasury bailout of 2008 also initiated a government ownership stake in the financial sector. This means that, going forward, political forces are likely to influence decisionmaking in the extension of credit and the allocation of capital. Government, for example, might push banks to aid borrowers with poor credit histories, to subsidize politically connected industries, or to lend in the districts of powerful legislators. Government pressure is difficult for banks to resist, since government can threaten to withdraw its ownership stake or promise further injections whenever it wants to modify bank behavior. Further, bailing out banks sets a precedent for bailing out other industries. Thus, the long-run implications of bailout are unambiguously bad.

Bailout is superior to bankruptcy, therefore, only if allowing bank failures would cause or exacerbate a credit crunch. Neither theory nor evidence, however, makes a compelling case for such an effect. As a theoretical matter, failure by a bank means that it cannot extend credit, but this means a profit opportunity exists for someone else. As an empirical matter, it is difficult to establish whether panics cause credit freezes or underlying adverse shocks to the economy cause both reduced lending and panics. Ben Bernanke's famous paper on the Great Depression (Bernanke 1983) suffers exactly this problem; it shows that bank failures and output losses are correlated, but it does not pin down the direction of causation.

This is not to deny that credit freezes occur and cause harm, nor to assert that credit markets would have been healthy under the bankruptcy approach. Rather, the claim is that

overinvestment in housing and the excessive level of housing prices that existed in the United States meant that an unwinding was necessary to make the economy healthy. This restructuring implied reduced residential investment, declines in housing prices, plus shrinkage and consolidation of the banking sector. All of this would plausibly have generated a recession, even without any credit freeze, and the recession—along with increased awareness of the risks of mortgage lending—would have caused lending to contract, again even without a credit crunch. Thus, it is not obvious how much of the credit freeze was due to bank failures versus negative shocks to the underlying fundamentals.

In fact, the bailout might have exacerbated the credit crunch. The announcement that the Treasury was considering a bailout likely scared markets by suggesting the economy was worse than markets recognized (see Macey 2008). Likewise, the announcement may have encouraged a credit freeze because bankers did not want to realize their losses or sell their institutions to acquiring firms if government was going to get them off the hook. The bailout introduced uncertainty because no one knew what the bailout meant: how much, what form, for whom, for how long, with what restrictions, and so on.[13] The bailout also did little to make bank balance sheets transparent, yet the market's inability to determine who was solvent was plausibly a key reason for the freeze. Plus, banks can respond to capital injections by paying bonuses to executives and dividends to shareholders, or by hoarding cash; nothing guarantees they will lend out capital injections.[14]

Thus, the bailout had huge potential for counterproductive impacts and at best an uncertain prospect of alleviating the credit crunch or ameliorating the recession. This means

[13] Higgs (1997) provides suggestive evidence that uncertainty created by policymakers contributed to the length of the Great Depression.

[14] See Bordo and Schwartz (1998, 2000) for evidence on both the tendency for bailouts to exacerbate moral hazard and the ability of bailouts to improve economic performance.

that allowing further failures would have been a price worth paying. In particular, the process of failure and bankruptcy would have countered the financial sector's temptation to "bank" on government largesse, so the bankruptcy approach would have created better incentives going forward for private behavior toward risk.

Lessons for the Future

In my assessment, the financial crisis yields two main lessons. The first is that redistribution to low-income households should be direct and on budget, not indirect and off-budget, as in subsidized mortgage credit. The second lesson is that the moral hazards from bailing out private risk-taking are substantial, even when these do not always appear immediately.

Adjusting policy to incorporate the first lesson is relatively easy: it requires elimination of specific, pre-existing policies such as Fannie Mae, Freddie Mac, the Federal Housing Administration, and so on. This might be hard politically, but at least the target is well defined.

Adjusting policy to avoid the creation of moral hazard is harder. A few specific programs, such as the Pension Benefit Guarantee Corporation, are ripe for elimination from this perspective, but policymakers have many ways to bail out private risk-taking. Even elimination of agencies like the FDIC and the Federal Reserve—setting aside whether this makes sense overall—would not prevent a determined Treasury from bailing out banks. Thus, the only real constraint on such flawed government policy is increased recognition of its long-term costs.

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Figure 1: Real GDP

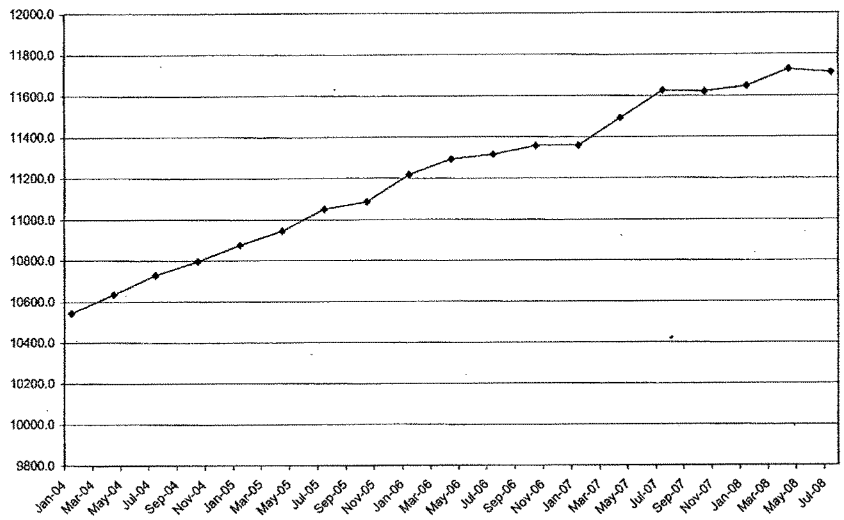


Figure 2: Index of Industrial Production

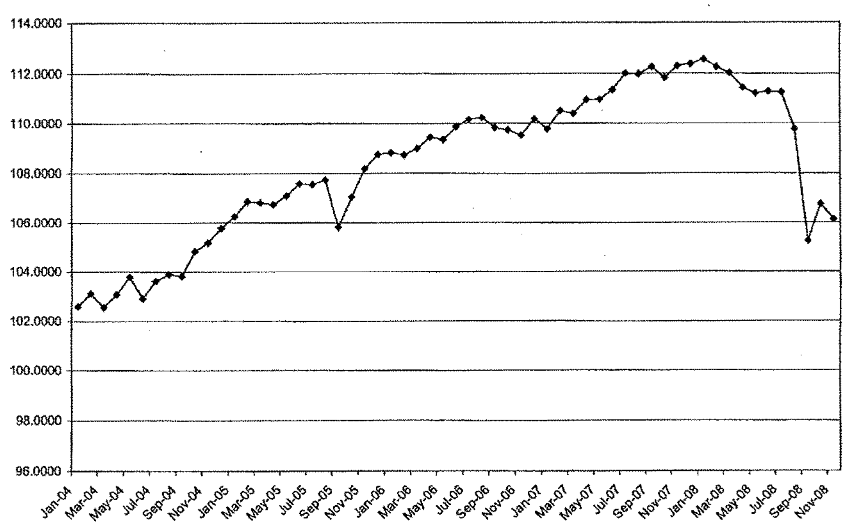


Figure 3: Real Retail Sales

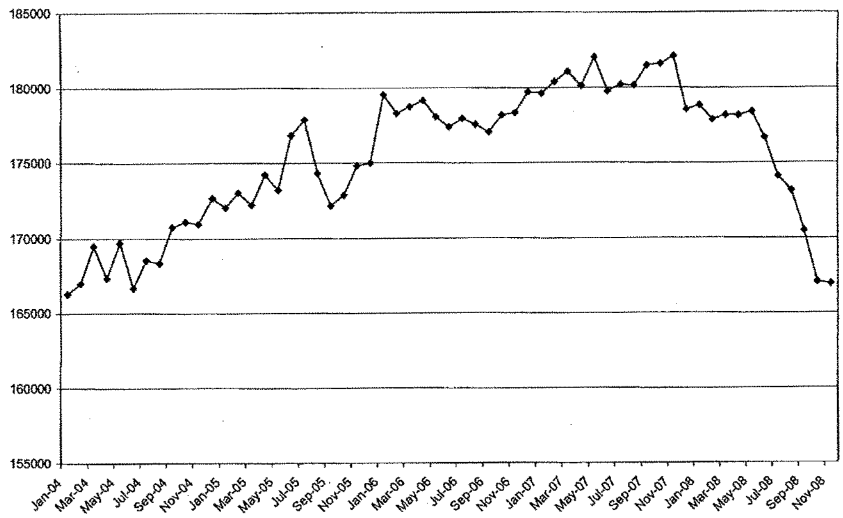


Figure 4: Employment

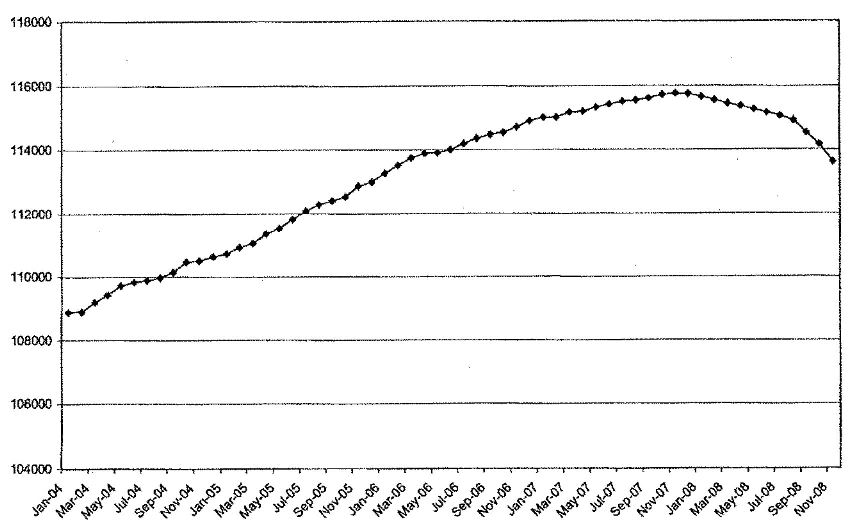


Figure 5: Housing Prices (Case-Shiller)

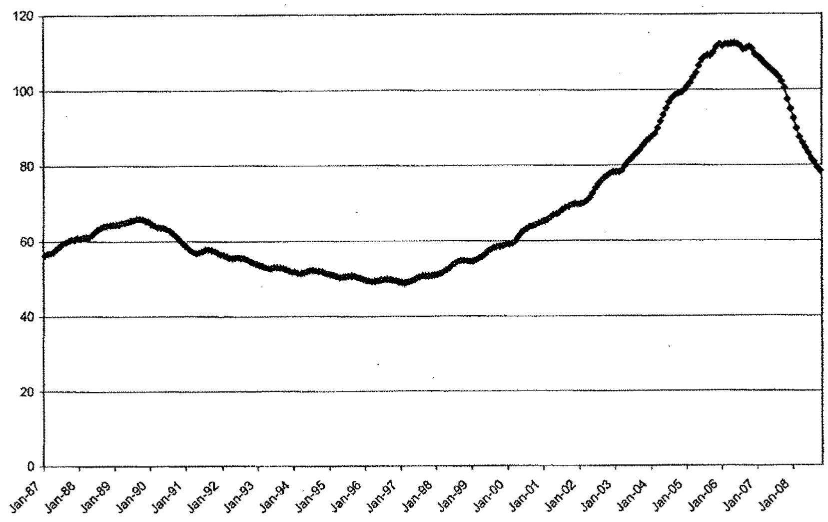


Figure 6: Homeownership Rate

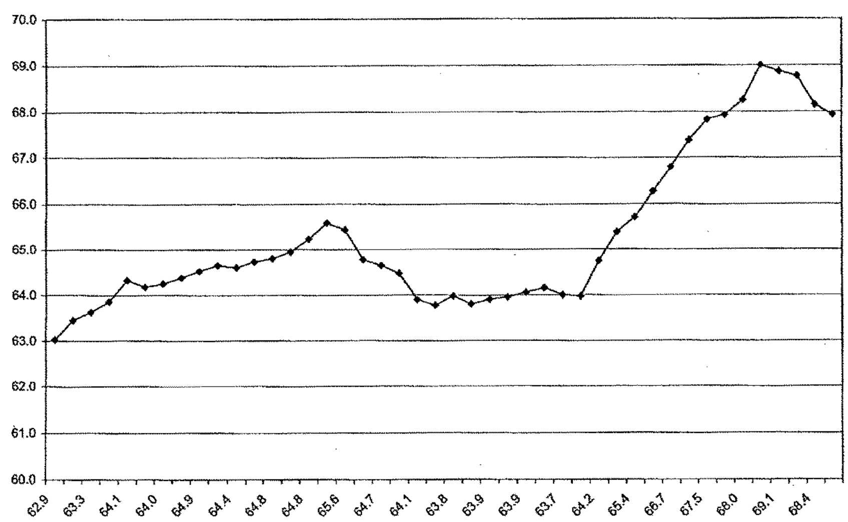


Figure 7: Real Housing Investment

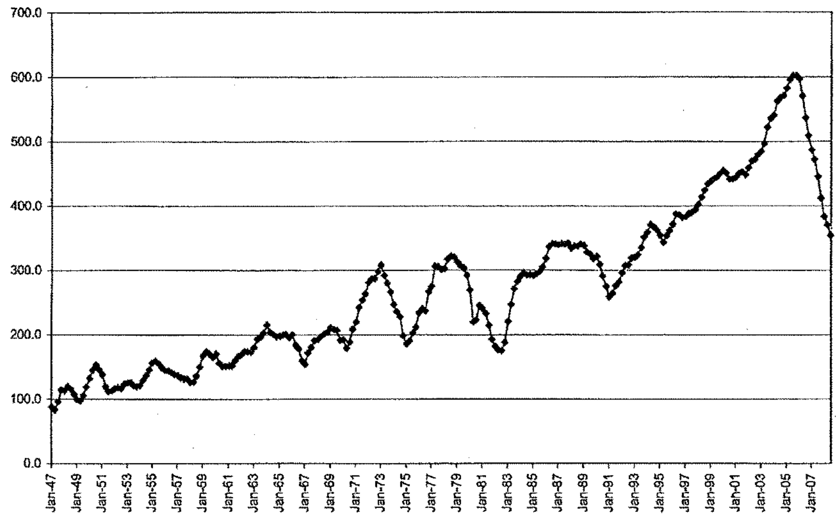


Figure 8: Real Stock Prices

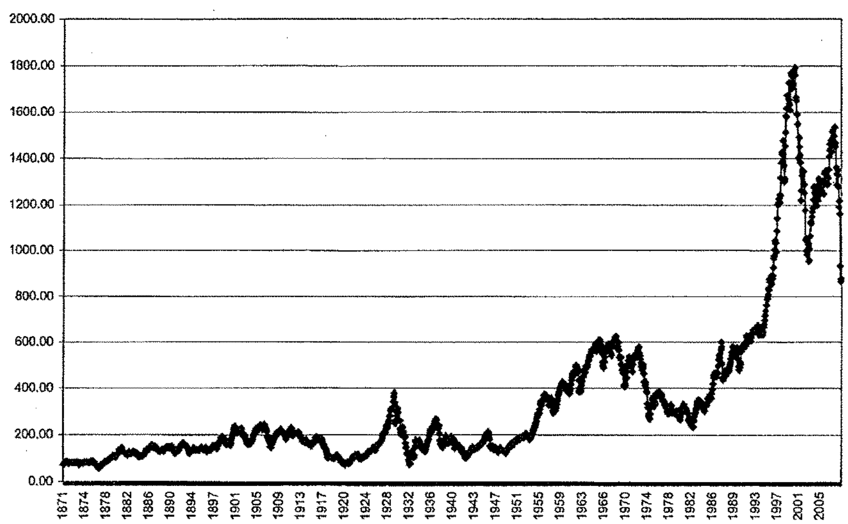
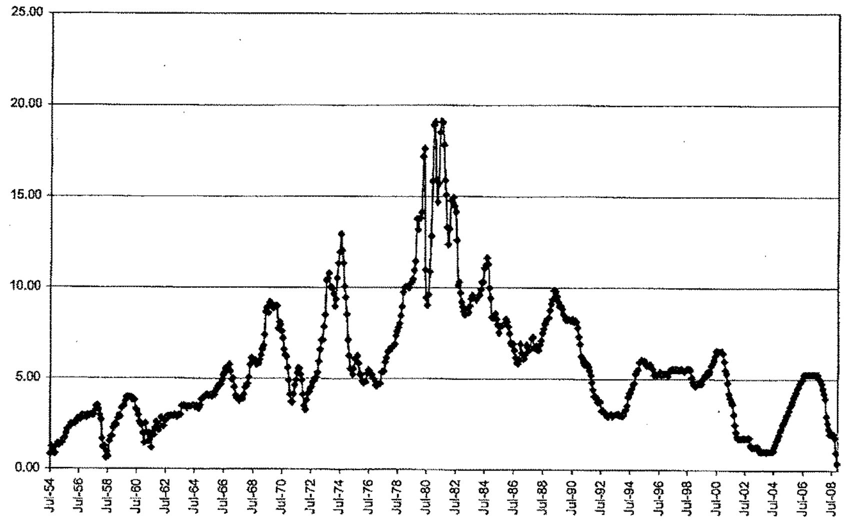


Figure 9: Effective Federal Funds Rate



STATEMENT BY PAUL A. VOLCKER
BEFORE THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES
OF THE
HOUSE OF REPRESENTATIVES
SEPTEMBER 24, 2009

Mr. Chairman, Members of the Committee:

I appreciate the opportunity to appear before you this morning. You are dealing with critically important issues. The laws passed in the 1930's successfully dealt with the grave weaknesses in the financial system at that time, weaknesses that contributed to the severity of the Great Depression. The legislation you are debating this year should set out a constructive path for a reformed financial system for years ahead.

Now the financial pressures have eased and there are signs of renewed economic growth. There are some on "Wall Street" who would like to return to "business as usual". After all, for a time, and for some that system was enormously remunerative. However, it placed at risk not only the American economy, but also large parts of the

world economy. The challenge is not to paper over or tinker around the edges of the broken system. We need to minimize the danger that the uncertainties and risks inherent in the functioning of a market-based financial system do not again jeopardize the functioning and foundation of our economy.

Over recent months the Administration has set out important proposals which, taken together and implemented, would provide a reformed framework for financial regulation and supervision. There are key elements of the Administration's approach that I believe deserve your full support. I particularly welcome the strong reaffirmation of one long-standing principle - the separation of banking from commerce - that has long characterized the American approach toward financial regulation. In practice, over a number of years that approach has been eroded by loopholes in the legal framework and by technological changes in financial instruments and the nature of banking. As emergency measures, further exceptions to the rule were accepted in the face of the severe crisis.

Failure to close those existing loopholes will inevitably weaken needed prudential safeguards and raise difficult questions about the extent of "moral hazard", an issue that looms very large in the light of events of the past year. It is those events - including particularly the rescue of money market mutual funds and the decisions to broaden direct access by non-banks to Federal Reserve credit facilities - that point to the need for strong enforcement of the distinction between banks and other financial or commercial institutions.

Important parts of the Administration's proposed reforms can be - and some are being - implemented and enforced under existing authority. The Treasury has set out principles for capital and liquidity standards. Other prudential approaches are under consideration. Most notably risk management practices, for banks and certain other regulated institutions have been placed under urgent review. At the supervisors' initiative, useful and needed steps are being taken to encourage more prudent compensation practices.

Registration and certain reporting requirements for hedge funds and private equity funds will require your support. Substantial progress is being made on a voluntary basis in the area of derivative markets, including particularly in clearance and settlement arrangements. That work will also need to be reinforced by further grants of legislative authority to appropriate regulatory agencies, including clarification of the overlapping jurisdiction of the SEC and the CFTC.

These are needed steps toward a stronger reformed financial system. However, I want to emphasize two inter-related issues of fundamental importance that run across the more particular elements of reform. One is a matter of broad regulatory practice: how to deal with the insidious, potentially risk-enhancing, spread of "moral hazard", the presumption that systemically important institutions may be protected in the face of imminent failure. The overlapping question is one of administrative responsibility: in particular the appropriate role of the central bank (the Federal Reserve) in regulation, supervision and oversight of the financial system.

However well justified in terms of dealing with the extreme threats to the financial system in the midst of crisis, the emergency actions of the Federal Reserve, the Treasury, and ultimately the Congress to protect the viability of particular institutions - their bond holders and to some extent even their stockholders - have inevitably left an indelible mark on attitudes and behavior patterns of market participants.

- Will not the pattern of protection for the largest banks and their holding companies tend to encourage greater risk-taking, including active participation in volatile capital markets, especially when compensation practices so greatly reward short-term success?

- Are community or regional banks to be deemed "too small to save", raising questions of competitive viability?

- Does not the extension of support to non-banks, and even to affiliates of commercial firms, undercut the banking/commerce divide, ultimately weakening the commercial banking system?

- Will not investors in money market mutual funds find reassurance in the fact that when push came to shove, the Treasury with an extreme interpretation of its authority, took action to preserve those funds ability to meet their declared commitment to pay their investors at par upon demand?

What all this amounts to is an unintended and unanticipated extension of the official "safety net", an arrangement designed decades ago to protect the stability of the commercial banking system. The obvious danger is that with the passage of time, risk-taking will be encouraged and efforts at prudential restraint will be resisted. Ultimately, the possibility of further crises - even greater crises - will increase.

There is no easy answer, no one-size fits all contingencies. Experience, not only here but in every country with highly developed, inter-connected financial systems and institutions bears out one point. Governments are not willing to withhold financial and other support for failing institutions when there is a clear threat to the intertwined fabric of the financial system. What can be done is to put in place arrangements to minimize the extent of emergency intervention and to damp expectations of government "bailouts".

The approach proposed by the Treasury is to designate in advance financial institutions "whose size, leverage, and interconnection could pose a threat to financial stability if it failed". Those institutions, bank or non-bank, connected to a commercial firm or not, would be subject to particularly strict and conservative prudential supervision and regulation. The Federal Reserve would be designated as consolidated supervisor. The precise criteria for designation as "systemically important" have not, so far as I know, been set out. However, the clear implication of such designation whether officially acknowledged or not will be that such institutions, in

whole or in part, will be sheltered by access to a Federal safety net in time of crisis; they will be broadly understood to be "too big to fail".

Think of the practical difficulties of such designation. Can we really anticipate which institutions will be systemically significant amid the uncertainties in future crises and the complex inter-relationships of markets? Was Long Term Capital Management, a hedge fund, systemically significant in 1998? Was Bear Stearns, but not Lehman? How about General Electric's huge financial affiliate, or the large affiliates of other substantial commercial firms? What about foreign institutions operating in the United States?

All hard questions. In practice the "border problem" seems intractable. In fair financial weather, the important institutions will feel competitively hobbled by stricter standards. In times of potential crisis, it would be the institution left out of the "too big to fail" club that will fear disadvantage.

I have done a little informal polling among friends familiar with financial markets. I asked, outside of commercial banking and insurance organizations already subject to substantial official regulation, how many financial institutions in the world should be considered systemically significant and protected from failure? The answers range from about 5 to maybe 25 or so.

Of course, we can't really know, not in this day, when "black swans" seem to be appearing more frequently, when sub-prime mortgages arise out of nowhere in a few years to undermine market stability, when opaque trading in complex derivatives become so large relative to underlying assets, and when more and more complex financial instruments limit the transparency of markets.

Rather than designate some particular systemically important institution, I take a more traditional view. Commercial banks, taken collectively, are certainly systemically important. Their basic role is to provide vital basic services to customers - payment services, a safe depository for liquid funds, credit for individuals

and businesses and financial advice. Since Adam Smith wrote his classic work, and even before, the risks of bank failures impairing economic activity have also been recognized.

The United States, as virtually all developed countries, for decades, ranging in our case back to the National Banking and the Federal Reserve Acts, have maintained a substantial supervisory and regulatory apparatus. It indeed is timely here in the U.S., as elsewhere, to review those arrangements and the particular responsibilities of the agencies involved. However that is resolved, it should be natural that the larger and more complicated banking institutions be subject to particularly close surveillance and supervision, with guidelines for capital, executive compensation and risk-management procedures enforced in the normal course of examinations.

As a general matter, I would exclude from commercial banking institutions, which are potential beneficiaries of official (i.e., taxpayer) financial support, certain risky activities entirely suitable for our capital markets.

Ownership or sponsorship of hedge funds and private equity funds should be among those prohibited activities. So should in my view a heavy volume of proprietary trading with its inherent risks. Some trading, it is reasonably argued, is necessary as part of a full service customer relationship. The distinction between "proprietary" and "customer-related" may be cloudy at the border. But surely by the active use of capital requirements and the exercise of supervisory authority, appropriate restraint can be maintained.

The point is not only the substantial risks inherent in capital market activities. There are deep-seated, almost unmanageable, conflicts of interest with normal banking relationships - individuals, businesses, investment management clients seeking credit, underwriting and unbiased advisory services. I also think we have learned enough about the challenges and distractions for management posed by the risks and complexities of highly diversified activities.

If the commercial banking system is to be protected and fit comfortably within the existing official safety net, there still will be potential problems with other risk-taking institutions active in the capital markets. I have suggested that, insurance companies apart, only a few such institutions are likely to pose truly systemic risk. Registration and reporting by hedge funds and private equity funds (above some de minimus size) should enable the relevant regulator to assess dangerous degrees of leverage, capital inadequacy, or other particularly risk-prone activity by particular institutions.

As a matter of broad policy, an assumption that those non-bank institutions would come into the framework of the Federal safety net should be discouraged. The credibility of that approach will need to be supported by legislation.

A designated regulatory agency will need to be provided authority to set rules for capital, leverage, and liquidity for those few institutions that may be large enough to pose systemic risk.

I also believe an approach proposed by the Administration and others should be supported. The basic concept is to provide a new "resolution regime" for insolvent or failing non-bank institutions of potential systemic importance. What is envisaged is appointment of a "conservator" or "liquidator" to take control of a financial institution defaulting, or in clear danger of defaulting, on its obligations. Authority should be provided to negotiate the exchange of debt for new stock if necessary to maintain the continuity of operations, to arrange a merger, or to arrange an orderly liquidation.

That authority, as I see it, is essential to both the Administration's approach and certainly to the approach I advocate. I recognize such an authority, preempting established bankruptcy proceedings, would be justified only by the exceptional and particular circumstances of a systemic breakdown. The approach is not, however, unprecedented. The FDIC has long had analogous authority for insured banks.

The events of the past year here and abroad have also emphasized the need for broad surveillance of the financial system. In the past, the focus has been largely on supervision of individual institutions. What has been lacking amid the rapid changes in markets and instruments is a sense of how different institutions may be interacting, and what new developments may be presenting new risks and require a regulatory response. (The rapid development of sub-prime mortgages and credit default swaps are recent examples of inadequately recognized destabilizing developments.)

To my mind, in most countries, and in the United States, it is to the central bank that we have looked for broad assessment of financial markets and to maintain continuity in markets, even if that responsibility is not spelled out in statute. It is, without doubt, the central bank to which governments, market participants, and the public look to in time of crisis. It is, after all, an extension of the responsibilities implied by the original Federal Reserve Act at the time when, effectively, banks were the financial system. It is, of course, only the Federal Reserve that has the resources to lend freely at

short notice, a matter well demonstrated in the past crisis.

I understand, and share, concern that the financial crisis has revealed weaknesses in our regulatory and supervisory agencies as well as in the activities of private financial institutions. There has been criticism of the Federal Reserve itself, and even proposals to remove responsibilities other than monetary policy, strictly defined, from the Fed.

I believe, based on many years experience, that would be a mistake. For one thing, enforcing a separation of monetary policy and supervisory policy would not serve either function well. The Federal Reserve Board should not become an academic seminar debating in its marble palace various approaches toward monetary policy without the leavening experience of direct contact with, and responsibility for, the world of finance and the institutions through which monetary policy is effected.

If some sense of that interconnection has been lost in recent years, even as destabilizing bubbles in the stock and mortgage market evolved, it should be reinforced by organizational changes. I am not alone in suggesting that a Fed governor should be nominated by the President and confirmed by the Senate as a second Vice Chairman of the Board with particular responsibility for overseeing Regulation and Supervision. The point is to pinpoint responsibility, including relevant reporting to the Congress, for a review of market developments and regulatory and supervisory practices. Staff authority, independence, professionalism, experience, and size should be reinforced.

Quite simply, it is the Federal Reserve that has (surely should have) the independence from political pressures, the prestige and the essential qualifications of experience to serve as overseer of the financial system. It should have ample authority to obtain needed information from both other regulatory agencies and from financial firms, to work with those agencies in identifying weaknesses in market institutions and practices, and, if necessary to call for changes in regulatory practice.

The Treasury, fully recognizing the need for such broad oversight, has essentially recommended a council of regulatory agencies under Treasury chairmanship. I write with some confidence that a council of variegated agencies with their own particular challenges, policies, and constituencies cannot be expected to efficiently and effectively serve as a coordinating body. In practice, the burden would be on the Treasury, an agency for which I have had enormous respect and pride and in which I have served in my years in Government. I also know that it would need to build staff, competence and experience in the regulatory arena from a standing start. It is subject more directly to funding constraints and political forces and direction that may inhibit action. The needed cooperation and coordination of regulatory and supervisory practice internationally has been, and I think should remain, heavily dependent on national central banks, most of which have a substantial role in prudential regulation.

In sum, I believe the needed oversight and coordinating role should be in the hands of the Federal Reserve rather than the Treasury. In considering the

responsibilities of the Federal Reserve, it does seem to me entirely appropriate that when under "unusual and exigent" circumstances the Fed is called upon to use emergency lending powers, it seek the formal assent of the President through the Treasury. I believe that has, in any event, properly been done as a matter of practice. However, with taxpayer money ultimately at risk, there should be no doubt about approval for the exercise of the emergency authority.

There is also an interesting question as to the period over which events are both "unusual and exigent". What is involved in emergency lending is the need to act immediately and forcefully, which only the Fed may be able to do. But after several months, the Congress working with the Administration should be able to determine the proper amount and time for continuing extraordinary assistance.

This is already a long statement, and I cannot cover other important points at issue, including protection for consumers and investors involved in financial transactions. In time, Congress must direct its attention to rebuilding the national mortgage market, avoiding, I trust, the now

failed approach of mingling private and public responsibilities of so-called Government Sponsored Enterprises. I also urge consideration of making a national insurance charter available to insurance companies willing to accept Federal prudential standards. Large issues with accounting and credit rating agencies remain.

Those are matters for another day. What is critically important is to establish now the basic framework for regulation and supervision, in the process recognizing the special role of the central bank. Going forward, I also urge that the United States recognize the need to coordinate with the authorities of the other major countries regarding the oversight of international banking organizations, the open and timely sharing of information, and greater clarity on home and host responsibilities, including dealing with failing institutions. This will greatly assist in the closing of regulatory gaps, and raise standards, and help in developing a "level playing field".

Written Testimony of Mark Zandi
Chief Economist and Cofounder Moody's Economy.com

Before the House Financial Services Committee

"Experts' Perspectives on Systemic Risk and Resolution Issues"

September 24, 2009

Mr. Chairman and members of the committee, thank you for the opportunity to testify on financial regulatory reform, a matter vital to the long-term health of the financial system and the economy. My remarks reflect my personal views and not those of my employer, Moody's Corporation.

The Obama administration's proposed financial regulatory reforms will, if largely enacted, result in a more stable and well-functioning financial system. I will list the five most important elements of regulatory reform and offer a few suggestions on how to make them more effective.

First, reform must establish a more orderly resolution process for large, systemically important financial firms. Regulators' uncertainty and delay in addressing the problems at broker-dealer Lehman Brothers and insurer AIG contributed significantly to the panic that hit the financial system in September of last year.

Financial institutions need a single, well-articulated and transparent resolution mechanism outside the bankruptcy process. Bankruptcy can be protracted and vary by jurisdiction; it thus is not suitable for resolving large, complex financial firms that get into trouble. The new resolution mechanism should preserve the system's stability while encouraging market discipline by imposing losses on shareholders and creditors and replacing senior management. Charging the Federal Deposit Insurance Corp. with the responsibility of resolving these institutions makes sense, given the efficient job the FDIC does handling failed depository institutions.

It is also important to require that financial firms maintain an acceptable resolution plan to guide regulators in the event of a failure. As part of this plan, institutions should be required to conduct annual stress tests based on different economic scenarios, similar to the exercise conducted by regulators and the largest bank holding companies this past spring. Such an exercise would be very therapeutic and could reveal how well financial institutions have prepared themselves to function in an economy that does not perform as anticipated.

Second, reform must address the too-big-to-fail problem, which has become a bigger problem in the wake of the financial crisis and the resulting consolidation of the financial services industry. The desire to break up too-big-to-fail institutions is understandable, but ultimately futile. There is no going back to the era of Glass-Steagall; breaking up the system's mammoth institutions would be too wrenching and would put U.S. institutions at a distinct competitive disadvantage vis-à-vis their large global competitors. Large institutions are also needed to finance and backstop the rest of the financial system. It is more efficient and practical for regulators to watch over these large institutions more intently and, by extension, the rest of the system.

Taxpayers are providing a substantial benefit to the shareholders and creditors of institutions considered too big to fail; therefore these institutions should meet higher standards for safety and soundness. As financial firms grow larger, they should be subject to greater disclosure requirements, required to hold more capital, satisfy stiffer liquidity requirements, and pay deposit and other insurance premiums commensurate with their size and the risks they pose to the system. Capital buffers and insurance premiums should increase in the good times when credit losses are low and profits strong and decline in the bad times.

Banning certain activities such as proprietary and hedge-fund trading within depository institutions is not preferable to requiring that these institutions hold more capital and meet higher standards to engage in these activities. The introduction of a new regulatory hybrid security that resembles long-term debt in

normal times but converts to equity in tough times is probably not necessary and may foment greater instability as creditors begin to anticipate when conditions could trigger such a conversion.

Third, reform should make financial markets more transparent. Opaque structured-finance markets facilitated the origination of trillions of dollars in poorly underwritten loans, which ignited the panic when these loans and the securities they supported went bad. Indeed, without reform, it is unlikely these markets will revive soon, which is necessary for credit to flow more freely to households and businesses.

The key to better functioning financial markets is increased transparency. Requiring that over-the-counter derivatives trading takes place on central clearing platforms makes sense; so does requiring that issuers of structured finance securities provide markets with the information necessary to evaluate the creditworthiness of the loans underlying the securities. Issuers of corporate equity and debt must provide extensive information to investors, but this is not the case for mortgage-backed or other asset-backed securities. The structure and composition of these investments are complex, yet they can be issued with limited information provided to the public. Having an independent party vet such data to ensure its accuracy and timeliness would also go a long way toward ensuring better lending and re-establishing confidence in these markets.

Fourth, reform should establish the Federal Reserve as a systemic risk regulator. The Fed is uniquely suited for this task, given its central position in the global financial system, its significant financial and intellectual resources, and its history of political independence. As a systemic risk regulator, the Fed can address the age-old problem that financial regulation tends to be procyclical, serving to reinforce changes in creditors' underwriting standards and thus the availability of credit. As a systemic risk regulator, the Fed would also have the responsibility to address asset bubbles, something it has thus far been reluctant to do. There are good reasons for this reluctance, but as the current crisis demonstrates, there are better reasons to take action. As a systemic regulator, the Fed could influence the amount of leverage and risk-taking—the essential ingredients of a bubble—in the financial system.

Establishing the new Financial Services Oversight Council as a systemic risk regulator would likely not work as well. The Council does not appear to be materially different from the interagency meetings that currently take place among regulators, which have not proved very effective in the past. For example, regulators failed to forge an effective consensus on guidance for alt-A and subprime mortgage lending until well after the financial crisis had been ignited.

The principal worry in making the Federal Reserve the systemic risk regulator is that its conduct of monetary policy may come under overly onerous oversight. Arguably one of the most important strengths of our financial system is the Federal Reserve's independence in setting monetary policy; it would be counterproductive if regulatory reform were to diminish even the appearance of this independence. This will become even more important in coming years, given prospects for large federal budget deficits and rising debt loads. Global investors will want to know that the Fed will do what is necessary to ensure inflation remains low and stable. To this end, it would be helpful if oversight of the Fed's regulatory functions were separated from oversight of its monetary policy responsibilities. One suggestion would be to establish semiannual reporting by the Fed to Congress on its regulatory activities, much like its current reporting to Congress on monetary policy.

Finally, reform should establish a new Consumer Financial Protection Agency to protect consumers of financial products. The CFPA should have rule-making, supervision, and enforcement authority. As is clear from the recent financial crisis, households have limited understanding of their obligations as borrowers or of the risks they take as investors. It is also clear that the current fractured regulatory framework overseeing consumer financial protection is inadequate. Much of the most egregious mortgage lending during the housing boom and bubble earlier in the decade was done by financial firms whose corporate structures such as REITs were designed specifically to fall between the regulatory cracks. There is no clear way to end this regulatory arbitrage within the current regulatory framework; the framework itself must be fundamentally changed.

The idea of a new agency has come under substantial criticism from financial institutions that fear it will stifle their ability to create new products and will raise the costs of existing ones. This is not an unreasonable concern, but it can be adequately addressed. The suggestion that the CFPA should require financial institutions to offer simple, plain-vanilla financial products to households should be dropped. Such a requirement could create substantial disincentives for institutions to add useful features to existing products and to offer new products. Moreover, it is important that the CFPA guide with a judicious hand. It must strike the appropriate balance between underregulating, which will result in bad lending that pushes too many households toward bankruptcy or foreclosure, and overregulating, which will stifle innovation, restrict credit for creditworthy borrowers, and lead to higher costs for all consumers. To this end, the head of the CFPA should be appointed by the president and confirmed by the Senate.

Criticism that the CFPA's activities would conflict with those of other prudential regulators seems overdone. The goals of the CFPA–to ensure that consumer financial products are safe–and of prudential regulators–to ensure that financial institutions are engaged in safe practices–are very consistent. Indeed, the CFPA would substantially increase the safety and soundness of the entire financial system by preventing lenders who offer irresponsibly aggressive financial products from leading others to adopt similar practices for fear of losing business. The CFPA will address the age-old bane of banking, a variation on Gresham's Law, in which bad lenders drive out the good.

There are also worries that the CFPA will upset the dual state-federal banking system that has been in place since the Civil War, resulting in greater net costs for lenders. The CFPA would establish a floor under consumer protection across states and make nationally chartered institutions subject to state regulation where that is more restrictive. National banks will have added costs to monitor and comply with state laws, but there are also benefits from more uniform financial regulation. To further limit costs, the CFPA should not allow states to discriminate against national banks and should allow preemption of state interest rate and usury laws. On net, the benefits of the CFPA will measurably outweigh the costs.

The Obama administration's proposed financial regulatory reform is much needed and reasonably well designed. The panic that roiled the financial system earlier this year has subsided, but the system remains far from normal, and credit remains severely impaired. Until credit flows more freely, the current economic recovery will not evolve into a self-sustaining expansion. Regulatory reform is vital to re-establishing confidence in the financial system, and thus fully reviving the economy. The administration's proposed regulatory framework fills most of the holes in the current one, and while such a framework would not have prevented the current crisis, it would have made the crisis measurably less severe. More importantly, it will reduce the odds and severity of future financial crises.

Overcoming Short-termism:

A Call for a More Responsible Approach to Investment and Business Management

THE ASPEN INSTITUTE
BUSINESS & SOCIETY PROGRAM

September 9, 2009

Shareholder Short-Termism

The word "shareholders" evokes images of mom-and-pop investors saving for their retirement or their children's college tuition. Individual investors do participate directly in the market, but they are mostly passive and unorganized and their role has diminished in recent years. The largest and most influential shareholders today are institutions — including pension funds, mutual funds, private investment (or "hedge") funds, endowments and sovereign wealth funds — many of which serve as agents for the providers of capital, their ultimate investors. For example, one-third of U.S. corporate equity today is held by mutual funds and hedge funds.

The diversity of investment vehicles contributes to healthy competition and liquidity and is a strength of our capital markets. Properly incentivized institutions of different kinds can contribute to long-term wealth creation. However, the influence of money managers, mutual funds and hedge funds (and those intermediaries who provide them capital) who focus on short-term stock price performance, and/or favor high-leverage and high-risk corporate strategies designed to produce high short-term returns, present at least three problems:

- First, high rates of portfolio turnover harm ultimate investors' returns, since the costs associated with frequent trading can significantly erode gains.
- Second, fund managers with a primary focus on short-term trading gains have little reason to care about long-term corporate performance or externalities, and so are unlikely to exercise a positive role in promoting corporate policies, including appropriate proxy voting and corporate governance policies, that are beneficial and sustainable in the long-term. Risk-taking is an essential underpinning of our capitalist system, but the consequences to the corporation, and the economy, of high-risk strategies designed exclusively to produce high returns in the short-run is evident in recent market failures.
- Third, the focus of some short-term investors on quarterly earnings and other short-term metrics can harm the interests of shareholders seeking long-term growth and sustainable earnings, if managers and boards pursue strategies simply to satisfy those short-term investors. This, in turn, may put a corporation's future at risk.

If corporate law or other public policy mechanisms grant investors additional rights, we believe it is vital that all institutional investors and related intermediaries be properly incentivized to focus on the interest of promoting sustainable, long-term growth.

Encouraging investors and intermediaries representing investors to adopt a long-term perspective will ultimately encourage and empower boards of directors to adopt long-term strategies for growth and sustainable earnings, and to rely on long-term, forward-looking metrics in the consideration of compensation and performance incentives. In the absence of real changes in the focus of institutional investors and related intermediaries, the various corporate governance reforms currently being discussed are unlikely to reduce the likelihood of boards and managers responding to short-term pressures. Accordingly, the recommendations in this report take on great importance.

Call to Action: Key Leverage Points

We repeat, short-termism is not limited to the behavior of a few investors or intermediaries; it is system-wide, with contributions by and interdependency among corporate managers, boards, investment advisers, providers of capital, and government. Thus, effective change will result from a comprehensive rather than piecemeal approach. We present the following recommendations to focus attention and dialogue on the intricate problems of short-termism and what we believe are the key leverage points to return to a responsible and balanced approach to business and investment.

1. **Market Incentives**: encourage more patient capital
2. **Fiduciary Duty**: better align interests of financial intermediaries and their investors
3. **Transparency**: strengthen investor disclosures

Key Leverage Point 1—Market Incentives: Encourage Patient Capital

The first key leverage point, market incentives to encourage patient capital, is likely to be the most effective mechanism to encourage long-term focus by investors. Capitalism is a powerful economic and societal force which, if properly directed, can have a hugely beneficial impact on society at all levels. By enlisting natural market forces and establishing incentives for market actors to modify their respective behaviors, the following recommendations encourage patient capital, discourage investor 'churning', and generally reinforce society's long-term goals.

- Revise capital gains tax provisions or implement an excise tax in ways that are designed to discourage excessive share trading and encourage longer-term share ownership. Capital gains tax rates might be set on a descending scale based on the number of years a security is held. [1] An excise tax could be imposed that would also allow for the inclusion of tax-exempt and other investment entities.

- Remove limitations on capital loss deductibility for very long-term holdings, now capped at $3,000 per year for losses related to holdings of any duration.[2]

- In exchange for enhancing shareholder participation rights, consider adopting minimum holding periods or time-based vesting, along the lines of the one-year holding period required under the SEC proxy access proposal currently under review.[3]

Key Leverage Point 2—Fiduciary Duty: Better Align Interests of Financial Intermediaries and Investors

The second key leverage point is focused on ensuring that the fiduciary duties of financial intermediaries are clarified, enhanced and rigorously enforced to better align the interests of the intermediaries and the long-term interests of investors.

Federal subsidies help American investors save for purposes vital to our nation's and people's well-being: retirement and college savings. These policies in turn create demand for the mutual fund industry—a demand that is growing due to the decline in defined benefit pension plans. Naturally, these policies are effective only to the extent fund managers invest prudently for the long-term, and avoid short-term behavior that generates costs and incurs excessive risk. Presently, however, many college savings, 401(k), and related retirement funds engage in behavior that is inconsistent with their investors' goals, as they trade securities, pay their managers, and engage in (or support) activism in pursuit of short-term financial objectives at the expense of long-term performance and careful analysis of fundamental risk. Another tension exists when pension funds are caused to pursue high returns in order to reduce pressure on their sponsors for greater contributions. These long-term funds may require structural changes, but should, in any event, be subject to clearer and more rigorously enforced enhanced fiduciary duties to address the disconnect between the interests of intermediaries and ultimate investor/beneficiaries.

For example, the Investment Advisers Act of 1940 applies to "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities."[4] While the Advisers Act does not expressly address the fiduciary duties of investment advisers, the U.S. Supreme Court has long recognized that such duties underlie the Advisers Act.[5] The Obama Administration has issued a proposal to establish a clear fiduciary duty for investment advisers as well as for brokers/dealers.[6]

In addition, ERISA, the 1974 federal law that governs some private pension plans and provides tax-advantaged status to such plans, and other acts (UPIA, UPMIFA, MPERS) that govern funds to be invested for beneficiaries with long-term horizons delineate the fiduciary duties of those responsible. ERISA, for example, explicitly imposes on fiduciaries a duty of loyalty and prudence, as well as a duty to diversify investments.

The challenge of addressing the misalignment between the interests of the ultimate investors/beneficiaries and society in the long run and the incentives and perceived duties of the institutional investor community and other financial intermediaries is considerable.[7] Improved alignment might be accomplished through the clarification of existing or creation of new federal laws or regulations, including the following:

- Apply a higher degree of accountability and enhanced fiduciary duties to financial intermediaries, by requiring increased disclosures on compensation, incentives, trading, policies on proxy voting and other matters that indicate compatibility (or lack thereof) with the fund's stated objectives, and the goals of the ultimate beneficiaries.

- Modify ERISA allowable investment practices through rule changes to promote long-term investing by those investors holding equity in tax-advantaged accounts.[8]

- Ensure, through clearer and more rigorously enforced fiduciary duties, that investment advisers of all types take into account, and clearly inform investors of, tax and other implications of changes made to encourage long-term holding as recommended herein.

- Pursue regulation or policy to base the compensation of long-term oriented fund managers on the fund's long-term performance and extend to such funds the compensation disclosure requirements that are currently applicable to operating companies.

Key Leverage Point 3—Transparency: Strengthen Investor Disclosures

The final leverage point, greater transparency in investor disclosures, can also play an important role in helping corporations maintain a long-term orientation. The advent of increasingly complex non-traditional structured and derivative arrangements has enabled some investors to influence corporate decision-making without being subject to duties to disclose the existence or nature of their positions or their plans. This lack of transparency undermines the efficacy of the disclosure regime and creates opportunities for investors to use their influence to achieve short-term gains at the expense of long-term value creation. These opportunities may take many forms. To cite some extremes, they range from an activist who becomes a formal shareholder with voting power while simultaneously "shorting" a corporation's shares or entering into a derivatives contract to hedge away its economic interest, to an investor who owns shares of one company and uses that position to increase the value of its holdings in another company instead. There are other more sophisticated techniques. Updated disclosure rules that take into account these complex but increasingly common arrangements can play a significant role in helping corporations maintain a long-term orientation by encouraging investment behavior consistent with longer term value creation and providing corporate decision-makers with a better understanding of the corporation's shareholders and their motivations.

Concluding Thoughts

The trend toward greater shareholder power as encapsulated in legislative proposals under consideration in the 2009 legislative session should be accompanied by greater investor and intermediary responsibility. Institutional investors now wield substantial power — power that affects American citizens as well as global capital markets. The maturation of the institutional investor community creates both opportunity and responsibility to promote the long-term health of capital markets and, in particular, to pursue investment policies and public policies that empower and encourage business managers and boards of directors to focus on sustainable value creation rather than evanescent short-term objectives.

For the purpose of stimulating dialogue, we have offered here key leverage points for addressing one part of market short-termism. The undersigned, who have a wide range of affiliations, backgrounds and experience as participants in and students of the capital markets, are united in urging prompt and serious consideration of these policy initiatives which will, we believe, promote the sustainable growth and investment returns that are essential to healthy capital markets.

Appendix: Inputs to this Process

Since 2004, the Aspen Institute Business and Society Program, and specifically its Corporate Values Strategy Group (CVSG) has been facilitating dialogue among corporations, organized labor, public pensions and other institutional investors, and government, academic and judicial leaders. Organized around the pervasive and destructive problem of market short-termism, CVSG aims to promote business, government and market practices that curb short-termism and refocus the relevant players on creating long-term value for all stakeholders, with special focus on augmenting the voice of long-term oriented investors.

The Aspen Principles on Long-Term Value Creation, released to the public in June 2007, served as a starting place for its work on public policy. Drafted under the leadership of CVSG members including senior-level representatives from business, corporate governance, public pensions and organized labor, the Principles represent a consensus of "strange bedfellows" on actions aimed at counteracting short-term focus at the company level, and that may have broader ripple effects throughout the wider market. The Principles urge companies to define firm-specific metrics of long-term value, and then use these metrics both to communicate with investors around long-term measures and activities, and to better align compensation of executives and investors with the creation of long-term value.[1]

*We wish to acknowledge **Rebecca Darr** of the Aspen Institute Business & Society Program, **Damon Silvers** of the AFL-CIO and **Vice Chancellor Leo Strine, Jr.** of the Delaware Chancery Court for their energy and intellectual contributions that propelled this Aspen CVSG process.*

Endnotes:

[1] The Obama Administration has called for an increase in the longer-term capital gains rate to 20 percent. Instead, if a choice is made to implement this idea through capital gains, the Administration may consider a capital gains rate that is positively and dramatically skewed toward longer-term holdings.

[2] The tax treatment of a capital loss for non-corporate taxpayers that provides a $3,000 annual limitation on the deduction against ordinary income has been in place since the 1976 Tax Act. In recent years a number of proposals have been put forward to increase the $3,000 yearly limit on a capital loss deduction against ordinary income. While a higher deduction limit makes sense to account for inflation, we suggest that a capital loss tax policy should be implemented that favors very long-term losses, for example when one sells an asset that has been held for 10+ years or longer at a loss, a 100% deduction against ordinary income in the year in which the asset sale occurs is allowed.

[1] Aspen Institute Business & Society Program, "Guiding Principles for Long-Term Value Creation," June 2007. At: http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/Aspen_Principles_with_signers_April_09.pdf

[3] The SEC's proposed proxy access rules, issued June 10 and open for comment until August 17, 2009, require a holding period of 1 year. See http://www.sec.gov/news/press/2009/2009-116.htm. In addition, on April 10, 2009, amendments to the Delaware General Corporation Law were signed into law that facilitate proxy access and reimbursement of proxy solicitation expenses.

[4] Investment Advisers Act of 1940, §202(11).

[5] In *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963), the U.S. Supreme Court held that the Advisers Act, "reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser, consciously or unconsciously, to render advice which was not disinterested." The Court further held that the Advisers Act imposes an affirmative duty on the part of investment advisers to conduct their business with "utmost good faith and full and fair disclosure of all material facts" as well as an obligation to employ "reasonable care to avoid misleading clients." Section 206 of the Advisers Act has been interpreted to impose a fiduciary obligation on investment advisers, thereby requiring that investment advisers act, at all times, "in the best interest of the fund and its investors" and provide "full and fair disclosure of all materials facts" to both investors and independent trustees. *SEC v. Tambone*, 550 F.3d 106, 147 (2009).

[6] The Administration's proposal in the "Investor Protection Act of 2009" would enable the SEC to define "the standards of conduct for all brokers, dealers, and investment advisers, in providing investment advice about securities to retail customers or clients (and such other customers or clients as the Commission may by rule provide), shall be to act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice." The SEC would also be required to "examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems contrary to the public interest and the interests of investors." Accessed 26 July 2009 at: http://ustreas.gov/press/releases/docs/tg205071009.pdf.

[7] "More than eighty percent of the nation's liquid, investable wealth is managed by trustees and investment committees." See "Prudent Practices for Investment Advisers: Defining a Global Fiduciary Standard of Excellence," Fiduciary 360, 2006, p. 8.

[8] The investment horizon for pension plans is by its very nature long-term. While short-term adjustments to rebalance the investment portfolio may be necessary to reflect changing market conditions, the goal of any retirement plan is to produce income for the participant sufficient to fund, in whole or in part, retirement. That requires planning for the long-term. The switch from defined benefit to defined contribution retirement plans further complicates matters, as individuals are now being asked to create a portfolio.

ERISA recognizes the basic principle of long-term horizons, a view that is further supported by U.S. Department of Labor regulations and various court interpretations. While a legal standard exists, nevertheless, there is no mechanism to impose or incent the fiduciary obligation on a plan's investment decisions from the perspective of the plan's beneficiary interests. Furthermore, the Pension Benefit Guaranty Corporation (PBGC) does not have a mechanism or the mission to do so, despite being the agency that partially bears the failure of private pensions.

"The U.S. Department of Labor, which administers and enforces ERISA, has promulgated regulations providing a safe harbor for fiduciaries of participant-direct plans who select investments 'designed to provide long-term appreciation and capital preservation' in circumstances where the participant has failed to select investment options. 29 C.F.R. 2250. 404c-5(e)(4). Courts interpreting ERISA have similarly endorsed long-term investment strategies by retirement plan fiduciaries. As one court explained, an 'investment strategy to pick solid funds and stay with them long-term is fully consistent with the duties of prudence imposed on ERISA fiduciaries.' *Jenkins v. Yager*, 444 F.3d 916, 915 (7th Cir. 2006). As another court put it, a 'buy and hold strategy' is 'particularly appropriate for pension investments,' as it is 'unaffected by the volatility that accompanies the announcement of particular pieces of good and bad news.' *Rogers, v. Baxter Int'l. Inc.*, 521 F.3d 702, 705 (7th Cir. 2002)." (Source: Personal email from Paul Blankenstein, Gibson, Dunn & Crutcher LLP, 6 July 2009.)

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