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SYSTEMIC RISK: ARE SOME INSTITUTIONS TOO BIG TO FAIL AND IF SO, WHAT SHOULD WE DO ABOUT IT?

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

JULY 21, 2009

Printed for the use of the Committee on Financial Services

Serial No. 111–65

U.S. GOVERNMENT PRINTING OFFICE

53–245 PDF WASHINGTON : 2009

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

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SYSTEMIC RISK: ARE SOME INSTITUTIONS TOO BIG TO FAIL AND IF SO, WHAT SHOULD WE DO ABOUT IT?

Tuesday, July 21, 2009

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

The committee met, pursuant to notice, at 2:03 p.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Maloney, Watt, Sherman, Moore of Kansas, Capuano, Clay, Green, Cleaver, Ellison, Perlmutter, Donnelly, Foster, Carson, Minnick, Kosmas, Himes, Peters; Bachus, Royce, Biggert, Capito, Hensarling, Garrett, Neugebauer, Bachmann, Marchant, McCarthy of California, Lee, Paulsen, and Lance.

The CHAIRMAN. The hearing will come to order.

Sometimes, we have hearings to find things out. That's not the unvarying reason why we have hearings, but sometimes we actually have hearings because we want to learn things. For me, this is one of those times.

There is a great disparity I have encountered between the overwhelming consensus that we do not like the effects of "too big to fail," and what to do about it.

It is a concept, it seems to me, more easily denounced than dismantled. And we, I think, have broad agreement in this committee that it's not a good thing and it's not helpful for a number of reasons.

And, you know, we are open to ways to deal with it. There are ways to deal with it indirectly and directly, but this is legitimately and we have a panel today unlike many of our panels.

It does not consist of practitioners, people in the financial industry, consumer advocates. It's as near as we can see people with good analytical skills, and I mean this literally. I think there is a great eagerness on the part of my colleagues to figure out what's the most appropriate way to deal with "too big to fail," and we are here to listen.

The gentleman from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman.

I am curious, and I too want to listen to our witnesses very carefully. I'm not sure I have been convinced of the proposition of "too big to fail," and if I have I haven't quite convinced myself that the cure is not worse than the illness. I'm not completely convinced

we're not kicking the economic calamity can down the road for future generations to deal with.

Now, back in the circumstances of last September and October, I believe there was fairly universal thought that Congress needed to act. Clearly, we disagreed on the plan on how best to do that. Even as a fiscal conservative, I was willing to put the full faith and credit of the United States on the line in what I perceived to be one of the first truly emergency situations I had seen since coming to Congress, although I hear the phrase every single day that I serve.

But as I look closely at firms that may be designated supposedly as too big to fail, the two that come to mind are certainly Fannie Mae and Freddie Mac. Again, these were creations not of a competitive market, but creations in a government laboratory that never would have existed in a competitive market. And so I guess I'm convinced that government can create firms that some may view as too big to fail, that can create systemic risk, but I'm more convinced that there aren't more systemic events than there are systemic firms. And I'm not sure as this Nation has followed down the line of bailout mania that we necessarily have a whole lot to show for it.

As we wake up today, we know since January that 2½ million more Americans have lost their jobs. We have, I believe, 9.5 percent unemployment. We're looking at the highest unemployment rate in a quarter of a century, and I feel that bailout begets bailout. Once we got away, for example, on TARP being about financial stability, bailing out Chrysler, bailing out GM, many of us said, we're going to throw good money after bad. They're going to end up in Chapter 11 anyway, and roughly $80 billion taxpayer dollars later, guess what? They did.

You know, how is that fair to Ford who actually had to take on more debt to try to survive? And so, you know, to what extent is it even fair? To what extent is it even smart once you go down the road to start bailing out these firms? And so many of us fear, and I have introduced legislation, that TARP is now, regardless of its noble design back in September, October of last year, has morphed into a $700 billion revolving bailout slush fund that frankly is doing more harm to the economy than good. Now, I do want there to be an opportunity for large financial firms that fall into financial distress to be resolved and resolved quickly.

That's why in the Republican financial markets reform bill there is a provision that would create in the Bankruptcy Code a new Bankruptcy chapter to do just this. But, you know, you have to ask yourself the question: Should it be the policy of the Federal Government to necessarily reward bad business models at the expense of good business models? And, by the way, apparently CIT was not necessarily on the Administration's list of "too big to fail" when apparently Uncle Sam wouldn't give them a bailout. Lo and behold! Look what happens. The market comes through.

Isn't that interesting? You know, instead of CIT, maybe we should say see, I told you so. Maybe you ought to give private investment an opportunity to work. Again, bailout begets bailout. It keeps private investment on the sidelines. I'm convinced that it is hampering our economic growth. It's hampering our job creation,

and I still look for the proof point that there are firms that are too big to fail, and that somehow by putting all this taxpayer liability exposure on the line, we're going to end up doing ourselves more good than harm.

I'm not convinced of it, I don't think the American people are convinced of it, and so what do we have? We have a nation of bailout mania, trillions of dollars of debt. I think there's a better way. I yield back the balance of my time.

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

Mr. SHERMAN. Thank you, Mr. Chairman.

Some say too big to fail, some say too interconnected to fail. Some of my constituents just think it's too well-connected to fail. We need to design a system for the future that is bailout free. I was disappointed when the Secretary of the Treasury testifying about derivatives said in effect by not answering my question that we should continue to allow derivatives to be written today, that he reserves the right to seek to bail out tomorrow.

We need to return to an economic system where bailout is not a possibility. We need to make sure that the resolution authority is extremely clear that it is not bailout authority. And we were still faced with this issue of what is too big to fail. Too big to fail means too big to exist. We cannot put the taxpayer in a position where entities are allowed to grow in their complexity or their size to the point where they can hold the American taxpayer hostage, and say, we're going to take risks. And if these risks turn out badly, you have to bail us out or the entire economy will suffer.

The solution is obvious: Prevent risks from being taken that endanger the entire economy. Now, we will be told that taking all these risks is somehow wonderful for the overall Wall Street system. I don't think the American people want to hear it. They want no bailouts in the future; no possibility of bailouts in the future; and they want a system designed where everyone on Wall Street and everyone in Washington can say no bailouts ever.

And if that means that our banks have to be smaller than their foreign competition, that is something I think the American people are ready to accept. So let us talk about breaking up those that are too big to fail before we talk about bailing them out, and hopefully we can, through better capital reserves and better regulation, eliminate both possibilities.

Thank you.

The CHAIRMAN. The gentleman from California for 2½ minutes, Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

I would like to thank the witnesses for coming here today to testify, and a special thanks to Peter Wallison from AEI who for years warned about the systemic threat posed by the Government-Sponsored Enterprises Fannie Mae and Freddie Mac. I got to know Peter back in the old days when he was raising these concerns.

Eventually, the Federal Reserve itself became convinced that Peter was absolutely right, and in about 2004, they began to warn on what he was warning that this represented a systemic threat to the financial system, not just here in the United States, but worldwide at one point, the Fed Chairman said.

You know, for years there was this belief that should Fannie and Freddie run into trouble, the Federal Government would support them. After all, they had a line into the Treasury. They were Government-Sponsored Enterprises, and as Peter was warning, that perception allowed Fannie and Freddie to borrow at rates normally reserved for branches of the Federal Government, to take on excessive risk, and produce profits for shareholders and executives while they crowded out their competition. This was normally the result of when you have a government subsidy, this was the consequence.

Well, the Federal Government had to step in to save Fannie and Freddie, and this could end up costing taxpayers $400 billion before it's through, besides the effect that it had on the housing market, the collapse of the housing market. Additionally, the Federal Government is taking drastic steps using trillions of dollars to prop-up failed institutions because it was believed these institutions were too big to fail. One of the most unfortunate consequences of the massive move to provide public assistance is that moral hazard may become more deeply imbedded in our financial markets.

We can and should take steps to eliminate the need and possibility of official bailouts in the future by avoiding labeling institutions as systematically important and providing an enhanced bankruptcy procedure to deal with non-bank financial institutions as an alternative to the course that we seem to be on. And this will provide clarity to the market. It will reduce the perceived government safety net, and lessen the moral hazard problem that has been created in recent months. In terms of the problems we're going to deal with looming in the future, I think we have to take lessons from the mistakes made. And this panel here today I think will give us an opportunity to discuss just such issues.

Thank you, Mr. Chairman.

The CHAIRMAN. The Federal requests, we have a couple. And I just want to comment in the meantime that some of the members have a different view of this hearing than I do.

We have heard very eloquent arguments against bailouts. Yes, that's what this hearing is for, to see how we can avoid pressures to do them. This is not a case where it is an assumption that we're going to have these large institutions and then figure out what we do if we get into trouble. Yes, precisely our role is to try to avoid the situation that the Bush Administration faced as it felt with regard to Bear Stearns and with regard to Lehman Brothers and Merrill Lynch and AIG.

All those happened under the Bush Administration, committed to free enterprise, but they felt that the consequences of the failures there would be disastrous. They had four different ways of dealing with them, none of them satisfactory to a lot of people, including themselves. So that is precisely the point of this hearing, so that one, you make it much less likely that there will be institutions in that situation, because of capital requirements and other things. And, two, that if you do get to that, there are ways of putting them down much less disruptively and much less expensively. So, as I said, this is not a reply of last year. It's enough to try and stop it.

Mr. Garrett of New Jersey for 2½ minutes.

Mr. GARRETT. I thank the chairman. I thank all the members of the panel as well, and specifically Mr. Mahoney, because I'm just

going to steal a little of your thunder because I think you made a good point in your remarks.

Mr. Mahoney is the dean of University of Virginia law school, and in your remarks of which you'll go into more detail—but I just want to point this out—you say what approach that is used—I think which is a Republican approach—believes that it was a mistake to bail out creditors of failed institutions when Bankruptcy proceedings were a tried and true alternative option. And this school of thought believes that policymakers should make it clear going forward that these mistakes will not be repeated and take steps to limit Treasuries and the Federal Reserve's ability to commit funds to failed institutions in the future.

So, I would just say that I think this approach is basically in a nutshell what the Republican Financial Service Reform Plan is all about. The other approach is to concede that the government will not refuse to bail out certain large institutions and attempt to take steps to deal with their risky behavior, as the chairman just said.

But, you know, if regulators fail to adequately limit their behavior, then a formal bailout framework would have to be set up in the meantime, and firms will be bailed out in a manner of course. So as I say, the Administration's plan basically follows this blueprint. The Administration's approach is premised on the anticipation that regulatory oversight would compensate for misaligned incentives. But we know time and time again, regulators have proved to be high on the curve and unable to keep up with the practices of companies that are tasked with regulating.

So we don't need to make their job any harder by encouraging destructive behavior to misaligned incentives. I do believe that the Republican plan is preferable, because it is based on a more sound premise. It would reduce moral hazard, because companies and creditors and counterparties would be responsible for the costs associated with their failures, not the taxpayers. And when companies and creditors have their own money on the line rather than other people's money, sounder decisions are made benefiting the entire financial system. You saw what happened when Fannie and Freddie profits were privatized and risks were socialized.

We don't want to repeat those mistakes time and again by following the Administration's proposal, which would create a whole privileged class of new Fannies and Freddie while institutionalizing an entire regime that would lead to expected and actual future bailouts. These would be bailouts that were paid for by the American taxpayer and smaller financial institutions, those that wouldn't even benefit from the government's "too big to fail" are premature in the first place.

I thank you, and I thank Mr. Mahoney.

The CHAIRMAN. We will now begin with Alice Rivlin.

STATEMENT OF ALICE M. RIVLIN, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Ms. RIVLIN. Thank you, Mr. Chairman.

I am really glad you're holding this hearing to focus on the question of systemic risk and how do we avoid getting into this situation again; and, as you pointed out, I don't think anybody wants

more bailouts ever if we can avoid it. I think that requires focusing on prevention.

How do we fix the financial system so that we don't have these perfect storms of a huge bubble that makes our system very prone to collapse? And then if this does happen, how do we make it less likely that we would have to resort to bailing out institutions?

So I think the task before this committee is first to repair the regulatory gaps and change the perverse incentives and reduce the chances that we will get another pervasive bubble. But, however, hard we try to do this, we have to recognize that there's no permanent fix. And I think one concept of systemic risk, what I call a macro system stabilizer that we need is an institution charged with looking continuously at the regulatory system at the markets and at perverse incentives that have crept into our system.

Because whatever rules we adopt will become obsolete as financial innovation progresses, and market participants find around the rules. This macro system stabilizer, I think, should be constantly searching for gaps, weak links, perverse incentives, and so forth and should make views public and work with other regulators and Congress to mitigate the problem. Now, the Obama Administration makes a case for such an institution, for a regulator with a broad mandate to collect information from all financial institutions and identify emerging risk. It proposes putting this responsibility in a financial services oversight counsel, chaired by the Treasury with its own expert staff.

That seems to me likely to be a cumbersome mechanism, and I would actually give this kind of responsibility to the Federal Reserve. I think the Fed should have the clear responsibility for spotting emerging risks, and trying to head them off before it has to pump trillions into the system to avert disaster. The Fed should make a periodic report to the Congress on the stability of the financial system and the possible threats to it, similar to the report you heard from Mr. Bernanke this morning about the economy. It should consult regularly with the Treasury and other regulators, but it should have the lead responsibility for monitoring systemic risk.

Spotting emerging risk would fit naturally with the Fed's efforts to monitor the state of the economy and the health of the financial sector in order to set and implement monetary policy. Having that explicit responsibility and more information on which to base it would enhance its effectiveness as a central bank. I would also suggest giving the Fed a new tool to control leverage across the financial system.

While lower interest rates may have contributed to the bubble, monetary policy has multiple objectives, and the short-term interest rate is a poor tool for controlling bubbles. The Fed needs a stronger tool, a control of leverage more generally. But the second task is one you have emphasized in your title, how to make the system less vulnerable to cascading failures, domino effects, due to the presence of large interconnected financial firms whose failure could bring down other firms and markets. This view of what happened could lead to policies to restrain the growth of large interconnected financial firms or even break them up.

The CHAIRMAN. Could I get unanimous consent? I think it's a complicated subject. We don't have a lot of members here, so would there be any objection to going to 7 minutes for the witnesses?

Hearing none, the witnesses get 7 minutes. It's not a lot of time, but at least it is a little more, so please continue.

Ms. RIVLIN. Okay. Thanks, Mr. Chairman.

Some have argued for the creation of a single, consolidated regulator with responsibility for all systemically important financial institutions. The Obama Administration proposes making the Fed the consolidated regulator for Tier 1 financial institutions. I believe that would be a mistake. It would be a mistake to identify the specific institutions deemed "too big to fail," and an even greater mistake to put this responsibility at the Federal Reserve.

It's hard to identify systemically important firms in advance. The attempt to do so and cordon them off might encourage risky behavior to move outside the cordon. Moreover, identifying systemically important institutions and giving them their own consolidated regulator tends to institutionalize too big to fail and create a new set of GSE-like institutions.

Higher capital requirements and stricter regulation for large, interconnected institutions make sense, but I would favor a continuum rather than a defined list with its own special regulator. There is no obvious place to put responsibility for regulating financial institutions, but it seems to me a mistake to give the Federal Reserve responsibility for consolidated prudential regulation of big interconnected companies as proposed by the Obama Administration. The skills needed by a central bank are different from those needed to run an effective regulatory institution.

The CHAIRMAN. Could you finish up if you have a last sentence or two?

Ms. RIVLIN. Pardon?

The CHAIRMAN. Do you have a last sentence or two?

Ms. RIVLIN. Okay. Let me just conclude, Mr. Chairman. In short, I think the Obama Administration has it backwards, that the general spotter of financial risk should be the Fed and that it would be a mistake to have a consolidated regulator of "too big to fail" institutions. It's a worse mistake to put at the Fed.

[The prepared statement of Ms. Rivlin can be found on page 68 of the appendix.]

The CHAIRMAN. Mr. Wallison?

STATEMENT OF PETER J. WALLISON, ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

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

Leaving aside Fannie Mae and Freddie Mac, which I think are a very special case, if there is such a thing as a firm that is too big to fail, it is only a large commercial bank. And we now have several of them that are enormous.

When we say that a firm is too big to fail, we mean that its failure could have a major, adverse effect on the entire economy. This is not simply a mere disruption of the economy. It would have to be a systemic breakdown. We can't define that very well, but it would have to be something greater than simply the kind of disrup-

tion that would occur from the failure of a firm. In my view, only a large commercial bank can create this kind of systemic breakdown.

When a large bank fails, its depositors are immediately deprived of the funds they expected to have to meet payrolls and to pay their bills. Smaller banks are depositors in the larger banks, so the failure of a large bank can send a cascade of losses through the economy. If there is such a thing as a systemic breakdown, this would be it. For the same reasons, it is difficult to see how a large non-bank financial institution, that is, a bank holding company, a securities firm, a finance company, or a hedge fund can cause systemic risk. And thus it is difficult to see why a non-bank can ever be, in terms we are talking about today, too big to fail.

Non-banks do not take deposits. They borrow for the short-, medium-, and long-term, but if they fail, their creditors don't suffer any immediate cash losses that would make it difficult for them to pay their bills. No one deposits his payroll or the money he expects to use for doing business with a securities firm or a finance company. In addition, their creditors are likely to be diversified lenders, so all their eggs are not in the same basket.

However, the freeze-up in lending that followed the collapse of Lehman Brothers has led some people to believe, and I think incorrectly, that Lehman caused that event. This is not accurate. They conclude that a non-bank financial firm can cause a systemic breakdown that it can thus be too big to fail. But Lehman's failure caused what is called a common shock, where a market freezes up because new information has come to light. The new information that came to light with Lehman's failure was that the government was not going to rescue every firm larger than Bear Stearns, which had been rescued 6 months before.

In this new light, every market participant had to reevaluate the risks of lending to everyone else. No wonder lending ground to a halt. Common shocks don't always cause a financial crisis. This one did, because virtually all large banks were thought at that time to be weak and unstable. They held large amounts of mortgage backed securities, later called toxic assets, that were of dubious value.

If the banks had not been weakened by these assets, they would have continued to lend to each other. There would not have been a freeze-up in lending and the investor panic that followed. So if we want to avoid another crisis like that, we should focus solely on ensuring that the banks—we're talking about commercial banks—are healthy. Other financial firms, no matter how large, are risk takers and should be allowed to fail.

Accordingly, if we want to deal with the problem of too big to fail and systemic risk bank regulation should be significantly reformed. Capital requirements for large banks should be increased as those banks get larger, especially if their assets grow faster than asset values generally. Higher capital requirements for larger banks would cause them to reconsider whether growth for its own sense really makes sense. Bank regulators should develop metrics or indicators of risk taking that banks should be required to publish regularly. This will enhance market discipline, which is fundamentally the way we control risk taking in the financial field.

Most important of all, Congress should create a systemic risk council on the foundation of the Presidents Working Group, which would include all the bank supervisors and other financial regulators. The council should have its own staff and should be charged with spotting the development of conditions in the banking industry, like the acquisition by virtually all banks of large amounts of toxic assets, that might make all major banks weak or unstable and leave them vulnerable to a common shock. If we keep our banks stable, we'll keep our financial system stable.

Finally, as a member of the Financial Crisis Inquiry Commission, I urge this committee to await our report before adopting any legislation.

Thank you.

[The prepared statement of Mr. Wallison can be found on page 79 of the appendix.]

STATEMENT OF SIMON JOHNSON, PROFESSOR, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

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

As you said at the beginning, the question, I think, is not controversial. The issue is to remove the possibility in the future that a large financial institution can come to the Executive Branch and say, "Either you bail us out, or there will be an enormous collapse in the financial system of this country and potentially globally."

And I think there are two broad responses to that, two ways of addressing that problem that are on the table.

The first is what I would call relatively technocratic adjustments, changing the rules around regulation or changing the rules around bankruptcy procedure.

I think there are some sensible ideas there, that are relatively small ideas. I don't believe they will fundamentally solve this problem.

The second approach is to reduce the size of these banks, and what we have learned, I think, over the past 9 months is a considerable amount about how small financial institutions can fail, and can fail without causing major systemic problems, both through an FDIC-type process, or through a market type process, as seen with the CIT Group.

Let me emphasize or underline the difference between these two approaches, and why making them smaller is both attractive and feasible.

I think that the key problem is this financial sector has become very persuasive. It has convinced itself, it has convinced its regulator, it has convinced many other people that it knows how to manage risks, that it understands what are large risks for itself.

And of course this is what Mr. Greenspan now concedes was a mistake in his assessment of the situation during the boom. He thought that the large firms that had a great deal to lose if things went badly understood these risks and would control them and manage them. And they didn't.

It's a massive failure of risk management and I see no indication either that the banks have improved this kind of risk management in the largest institutions, or that regulators are better able to spot this.

And while I agree with the idea we should have a systemic risk spotter of some kind, analytically and politically, it seems to me we're a long way from ever achieving that.

And if I may mention the lobbying of Fannie and Freddie on the one hand, and private banks on the other hand, it was just fantastic. These people are the best in the business, by all accounts, at speaking with many people, both with regard to legislation and of course detailed rules.

Again, I see no reason to think that if you tweak the technocratic structures, you will remove this power and this ability that these large financial institutions have brought to bear.

And it's not just in the last 5 to 10 years; it's historically in the United States and in many other countries, or perhaps most other countries the financial system has this kind of lobbying power, this kind of too-connected-to-fail issue raised by Mr. Sherman.

Now I think, Mr. Chairman, if you put it in those terms and if you look hard at the technocratic adjustments, the most promising solution is to adjust the capital requirements of the firms, as Mr. Wallison said, in such as fashion as it becomes less attractive and less profitable to become a big financial firm.

I also agree and would emphasize what Ms. Rivlin said, which is thinking about how to target leverage and control leverage, again through something akin to a modern version of margin requirements is very appealing in this situation.

It's about size. CIT Group was $80 billion in assets. Treasury and other—looked long and hard not at that before deciding not to bail it out.

I think from what we see right now, that was a smart decision. I think the market can take care of it.

The line they're drawing seems to be around $100 billion in assets. Financial institutions above $500 billion in assets right now clearly benefit from some sort of implicit government guarantee, going forward.

And that's a problem, that distorts incentives, exactly as many members of the committee emphasized it at the beginning.

So I think stronger capital requirements. You could also do this with a larger insurance premium for bigger banks. What have they cost? What has the failure of risk management at these major banks cost the United States?

Well, I would estimate that our privately held government debt will rise from around 40 percent of GDP, where it was initially to around 80 percent of GDP as the result of all the measures, direct and indirect, taken to save the financial system and to prevent this from turning into another Great Depression.

That's a huge cost, and at the end of the day, you actually have more concentrated economic power, a more concentrated political access influence—call it what you want—in the financial system.

So for 40 percent of GDP, we bought ourselves nothing in terms of reducing the level of system risk that we know now was very high, 2005–2007.

I think it's capital requirements and you can combine that with higher insurance premium, reflecting the system costs. That's a lot of money. And include a tax on leverage.

Now I want to, in my remaining 2 minutes, emphasize some issues of implementation I think are very important.

The first is in terms of timing. I think the capital requirements can be phased in over time. I think the advantage of an economy that's bottoming out and starting to recover, you don't have to do this right away. The firms will likely—not for sure—will likely not engage in the same kind of restless risk-taking in the next 2 to 3 years.

So there is some time to get ahead of this. But you really don't want to run through anything like the kind of boom that we have seen before. And of course this will reduce the profitability in this sector. No question about it.

And the industry will point this out. They will be very cross with you, and they will tell you that this undermines productivity growth, and job creation in the United States.

I see no evidence that is the case. I see no evidence that having an overleveraged financial system with excessive risk-taking does anything at all for growth in the real non-financial part of the economy.

Now I would emphasize, though, two important pieces of this that we should also consider and that are more tricky.

The first is foreign banks. So if we reduce the size of our banks, relative to the size of foreign banks, I think that does not create a competitive disadvantage for our industry. But it does raise the question of, "How should you treat foreign banks operating in the United States?"

For example, Deutsche Bank, or other big European banks, banks that are very big relative to the size of those economies in Europe, let alone the size of the banks that we may end up with.

Those banks, to the extent they operate in the United States, should be treated in the same way as U.S. banks. The capital requirements have to be high based on where you operate. And if you want to operate in the U.S. financial markets, that will have to be a requirement.

Otherwise, you get into a situation where the next bank that comes to the Treasury and says, you know, "It's bailout or collapse," will be a foreign bank, and that will be even more of a disaster than what we have faced recently.

The second transactional issue, and my final point is with regards to the resolutional authority, I think Congress is rightly considering very carefully the resolutional authority requested by the Treasury, and I think that broadly speaking, that's a good idea.

But I would emphasize, it is not sufficient. It's not a global resolutional authority. If a major multi-national bank comes to you with a problem and you know, you would like to say to them, "Go through bankruptcy," but then when you look at the details of that, you see it will be a complete mess, because of the cross-border dimensions of that business.

The same thing is true for a bailout. If you bail them out under your resolutional authority, it's also going to be a disaster unless you have a global agreement at the level of the G–20.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Johnson can be found on page 49 of the appendix.]

The CHAIRMAN. Mr. Zandi?

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

Mr. ZANDI. Thank you, Mr. Chairman, and members of the committee for the opportunity to be here today.

I am an employee of the Moody's Corporation, but my remarks today reflect only my own personal views. I will make five points in my remarks.

Point number one: I think the Administration's proposed financial regulatory reforms are much needed and reasonably well designed. The panic that was washing over the financial system earlier this year has subsided, but the system remains in significant disrepair. Our credit remains severely impaired.

By my own estimate, credit, household, and non-financial corporate debt outstanding fell in the second quarter. That would be the first time in the data that we have all the way back to World War II, and highlights the severity of the situation.

I think regulatory reform is vital to reestablishing confidence in the financial system, and thus reviving it, and thus by extension reviving the economy.

The Administration's regulatory reform fills in most of the holes in the current system, and while it would not have forestalled the current crisis, it certainly would have made it much less severe. And most importantly, I think it will reduce the risks and severity of future financial crises.

Point number two: A key aspect of the reform is establishing the Federal Reserve as a systemic risk regulator. I think that's a good idea. I think they're well suited for the task. They're in the most central position in the financial system. They have a lot of financial and importantly intellectual resources, and they have what's very key—a history of political independence.

They can also address the age-old problem of the procyclicality of regulation; that is, regulators allow very aggressive lending in the good times, allowing the good times to get even better, and tighten up in the bad times, when credit conditions are tough.

I also think as a systemic risk regulator, the Fed will have an opportunity to address asset bubbles. I think that's very important for them to do. There's a good reason for them to be reluctant to do so, but better ones for them to weigh against bubbles.

They, as a systemic risk regulator, will have the ability to influence the amount of leverage and risk-taking in the financial system, and those are key ingredients into the making of any bubble.

Point number three: I think establishing a consumer financial protection agency is a very good idea. It's clear from the current crisis that households really had very little idea of what their financial obligations were when they took on many of these products, a number of very good studies done by the Federal Reserve showing a complete lack of understanding. And even I, looking through some of these products, option ARMs, couldn't get through the spreadsheet. These are very, very difficult products. And I think it's very important that consumers be protected from this.

There is certainly going to be a lot of opposition to this. The financial services industry will claim that this will stifle innovation

and lead to higher costs. And it's true this agency probably won't get it right all the time, but I think it is important that they do get involved and make sure that households get what they pay for.

The Federal Reserve also seems to be a bit reluctant to give up some of its policy sway in this area. I'm a little bit confused by that. You know, I think they showed a lack of interest in this area in the boom and bubble. They have a lot of things on their plate. They'll have even more things on their plate if this reform goes through. As a systemic risk regulator, I think it makes a lot of sense to organize all of these responsibilities in one agency, so that they can focus on it and make sure that it works right.

Point number four: The reform proposal does have some serious limitations, in my view. The first limitation is it doesn't rationalize the current alphabet soup of regulators at the Federal and State level. That's a mistake. The one thing it does do is combine the OCC with the OTS. That's a reasonable thing to do, but that's it.

And so we now have the same Byzantine structure in place, and there will be regulatory arbitrage, and that ultimately will lead to future problems. I can understand the political problems in trying to combine these agencies, but I think that would be well worth the effort.

The second limitation is the reform does not adequately identify the lines of authority among regulators and the mechanisms for resolving difference. The new Financial Services Oversight Council, you know, it doesn't seem to me like it's that much different than these interagency meetings that are in place now, where the regulators get together and decide, you know, how they're going to address certain topics.

They can't agree, and it takes time for them to gain consensus. They couldn't gain consensus on stating simply that you can't make a mortgage loan to someone who can't pay you back. That didn't happen until well after the crisis was underway. So I'm not sure that solves the problem. I think the lines of authority need to be ironed out and articulated more clearly.

The third limitation is the reform proposal puts the Federal Reserve's political independence at greater risk, given its larger role in the financial system. Ensuring its independence is vital to the appropriate conduct of monetary policy. That's absolutely key; I wouldn't give that up for anything.

And the fourth limitation is the crisis has shown an uncomfortably large number of financial institutions are too big to fail. And that is they are failure risks undermining the system, giving policy makers little choice but to intervene.

The desire to break up these institutions is understandable, but ultimately it is feudal. There is no going back to the era of Glass-Steagall. Breaking up the banking system's mammoth institutions would be too wrenching and would put U.S. institutions at a distinct competitive disadvantage, vis-a-vis their large global competitors.

Large financial institutions are also needed to back-stop and finance the rest of the financial system. It is more efficient and practical for regulators to watch over these large institutions, and by extension, the rest of the system.

With the Fed as the systemic risk regulator, more effective oversight of too-big-to-fail institutions is possible. These large institutions should also be required to hold more capital, satisfy stiffer liquidity requirements, have greater disclosure requirements, and to pay deposit and perhaps other insurance premiums, commensurate with the risk they take and the risks that they pose to the entire financial system.

Finally, let me just say I think the proposed financial system regulatory reforms are as wide-ranging as anything that has been implemented since the 1930's Great Depression. The reforms are, in my view, generally well balanced, and if largely implemented, will result in a more steadfast, albeit slower-paced, financial system and it will have economic implications.

And I think that's important to realize, but I think necessary to take.

The Administration's reform proposal does not address a wide range of vital questions, but it is only appropriate that these questions be answered by legislators and regulators after careful deliberation. How these are answered will ultimately determine how well this reform effort will succeed.

Thank you.

[The prepared statement of Mr. Zandi can be found on page 86 of the appendix.]

The CHAIRMAN. Mr. Mahoney?

STATEMENT OF PAUL G. MAHONEY, DEAN, UNIVERSITY OF VIRGINIA SCHOOL OF LAW

Mr. MAHONEY. Thank you, Mr. Chairman, Ranking Member Bachus, and members of the committee. I appreciate the opportunity to present my views here today.

I will discuss those portions of the Administration's regulatory reform proposals that deal with the largest financial institutions, the so-called Tier 1 financial holding companies.

The Administration proposes a special resolution regime for financial holding companies outside the normal bankruptcy process, that would be triggered when the stability of the financial system is at risk.

And when the Treasury triggers the special resolution regime, it will have the authority to lend the institution money, purchase its assets, guarantee its liabilities, or provide equity capital with funds to be recaptured in the future from healthy institutions.

I think it is fair to use the term, "bailout" to describe that system.

There are two general schools of thought on how best to avoid future financial crises leading to widespread bailouts. The first holds that it was an error in the recent crisis to help creditors of failed institutions avoid losses that they would have realized in a normal bankruptcy proceeding, and that the focus of policy going forward should be to make it clear that the mistake will not be repeated.

The alternative is to concede that the government will ordinarily bail out large and systemically important financial institutions.

Under this approach, Congress should focus on limiting the risks that those institutions can take, in order to minimize the likelihood that they will become financially distressed.

Buy if those efforts fail, and a systemically important institution becomes financially distressed, a bailout will follow as a matter of course.

The Administration's financial reform blueprint takes this approach.

I think the first approach will produce a healthier financial services industry that will make fewer claims on taxpayer dollars going forward. It is based on a sounder premise—that the best way to reduce moral hazard is to ensure that economic agents bear the costs of their own mistakes.

The Administration's plan is premised on the view that regulatory oversight will compensate for misaligned incentives.

The central argument for trying to avoid bailouts through regulatory oversight rather than insisting that financial institutions bear the cost of their mistakes is that some institutions are too big to fail.

Putting those institutions through bankruptcy could spread contagion, meaning that other banks or financial institutions may also fail as a consequence.

Widespread bank failures in turn may reduce the availability of credit to the real economy, causing or exacerbating a recession.

There is debate over that analysis. But in any event, it is not clear that the magnitude of the problem is sufficient to justify the scale of government intervention that we have seen in the past year.

It is important to note that the loss of capital in the banking system in the recent crisis was not just the result of a temporary liquidity problem. It was the consequence of sharp declines in real estate and other asset values. A bailout can redistribute those losses to taxpayers, but it cannot avoid them.

The bankruptcy process is itself a means of recapitalizing an insolvent institution. Bankruptcy does not imply or require that the firm's assets, employees, and know-how disappear. Instead, it rearranges the external claims on the firm's assets and cash flows. The holders of the firm's equity may be wiped out entirely while unsecured creditors may have to substitute part or all of their debt claims for equity claims, thereby reestablishing a sound capital structure.

If the insolvent institution still has the skill and experience to facilitate credit formation, it will continue to do so under new ownership, management, and capital structure.

Of course, the bankruptcy process is subject to inefficiencies and delays, and those should be addressed. A more streamlined process may be appropriate for financial institutions, because they do have short-term creditors.

But this does not require an alternative regime of institutionalized bailouts. A bailout regime, unlike a bankruptcy regime, creates moral hazard problems that impose costs on the banking sector continuously and not just during crises.

Because creditors of too-big-to-fail financial institutions anticipate that they will be able to shift some or all of their losses to tax-

payers, they do not charge enough for the capital they provide. The financial institution in turn does not pay a sufficient price for taking risk.

The result is a dangerous feedback loop. Large banks have access to cheap capital, which causes them to grow even larger and more systemically important, while taking excessive risks—all of which increase the probability of a crisis.

Thus, a bailout regime leads to more frequent crises, even as it attempts to insulate creditors from them.

The Administration believes its proposal will alleviate moral hazard and decrease the concentration of risk in too-big-to-fail institutions. The idea is that these Tier 1 financial holding companies will be subject to more stringent capital rules that will reduce the amount of risk they can take and create a disincentive to become a Tier 1 financial holding company in the first place.

I think these disincentives are insufficient and implementation of the plan would increase and not decrease the concentration of risk. Once a firm has been designated a Tier 1 FHC, other financial institutions will view it as having an implicit government guarantee.

The theory behind the proposal is that this advantage will be offset by stricter capital requirements and other regulatory costs, which will on balance make the cost of capital higher for Tier 1 FHCs.

That analysis strikes me as wildly optimistic. Having an implicit government guarantee, Tier 1 financial holding companies will be extremely attractive counterparties, because risk transferred to them will in effect be transferred to the Federal Government.

Tier 1 financial holding companies will have a valuable asset in the form of the implicit guarantee that they will be able to sell in quantities limited only by the Fed's oversight. They will have powerful incentives to find mechanisms—new financial products, or creative off-balance sheet devices—to evade any limits on the risks they can purchase from the rest of the financial sector. And banks that are not already Tier 1 financial holding companies will have strong incentives to grow to the point that they become Tier FHCs in order to guarantee access to bailout money.

The fastest way to grow larger is to take bigger risks. An institution that can keep its gains while transferring losses to the government will engage in excessive risk-taking and excessive expansion, and the financial system as a whole will suffer more frequent crises.

Thank you, and I look forward to your questions.

[The prepared statement of Mr. Mahoney can be found on page 61 of the appendix.]

The CHAIRMAN. Thank you, Mr. Mahoney.

Let me save some discussion about perhaps—a number of you have talked about this idea in the Administration of the list of Tier 1 companies. And I understand the Administration understood that to mean that this would be a terrible—this would be a kind of probation for them.

It does seem very clear that most people think that the reaction of these companies to being on that list would be that of Brer Rabbit to the briar patch.

And I'm going to suggest then they substitute a different model. I think with regard to identifying the companies that might be particularly a systemic risk, the Administration is going to have to adopt the approach of Potter Stewart to pornography. They will be able to know it when they see it, but they're not going to have a pre-existing list. I think that idea is pretty much gone.

Now, Mr. Johnson, one interesting issue that you referred to that has been suggested to us is to vary the bank insurance fund according to the riskiness of the venture. Am I correct in that? Is that something that could be conceptualized, measured with some degree of appropriate specificity?

Mr. JOHNSON. Yes, Mr. Chairman. That is an idea that technical people, experts on the banking system, are working on. And the people I know who have made the most progress have work that's not yet public, but I would be happy to—

The CHAIRMAN. But if we had reached the level of reality that could be used as a basis for—

Mr. JOHNSON. It will be a paper by one of my colleagues at Jackson Hole this summer, so—

The CHAIRMAN. Okay. And you think that would have the effect of discouraging risk taking or penalizing those who took it?

Mr. JOHNSON. Yes, sir.

The CHAIRMAN. All right. That's a very important issue. By the way, it divides the banking community up. You see the smaller banks, the community banks who feel they have been victimized by the trash talking—the American Banking Association not so much.

Mr. Wallison, on the Systemic Risk Council that you talk about?

Mr. WALLISON. Yes?

The CHAIRMAN. That would be statutory, because the President's Working Group is just—

Mr. WALLISON. Yes—

The CHAIRMAN. You know, five people get together and hang out—so you would make that statutory—

Mr. WALLISON. Pursuant to an Executive Order, right.

The CHAIRMAN. All right. By Executive Order.

And then, I'm interested as to its powers. I do note you talk about the countercyclical macro potential that it could limit growth. When you say limit growth and you say by imposing higher capital—I assume by the way, there did seem to be an agreement here that as somebody imposed higher capital limits on institutions that grow, we don't mean simply proportional, we mean disproportionate. That is, its—

Mr. WALLISON. Yes—

The CHAIRMAN. You don't have a constant percentage, but that the bigger you are, the higher the percentage.

Mr. WALLISON. That's right.

The CHAIRMAN. And would you go beyond that to put actual limits on it? I mean, we have, for instance, the 10 percent deposit limit. That doesn't seem to me to do a great deal, but would you give the Systemic Risk Council the ability to, in establishing and enforcing a level of bank growth, could they do an absolute limit, so you can't get any bigger? Or would it only be through the capital requirements in other ways?

Mr. WALLISON. First of all, Mr. Chairman, I want to be sure we're talking—the term, "bank" is used very loosely. I am talking here about a commercial bank.

The CHAIRMAN. Yes.

Mr. WALLISON. Okay.

The CHAIRMAN. The way you're using it—depository—

Mr. WALLISON. Okay. Yes. And in that case, I don't believe that there should be any limits placed on the size of the institutions. But as capital rises, I think the institutions will be required themselves to limit their growth—

The CHAIRMAN. But you say here, "The Systemic Risk Council could be authorized to establish an acceptable limit of bank growth and impose appropriate limits on growth that are not consistent with the limits."

By that, do you mean capital requirements? There's no actual limit?

Mr. WALLISON. No, there's no actual limit on the size of the institution. But as the capital increases the institution will decide to put some sort of cap—

The CHAIRMAN. But—

Mr. WALLISON. I'm not for caps in general.

The CHAIRMAN. All right. The language frankly could have supported that. So you're not quoted in opposition to something—you are talking about strict capital—

What else would the Systemic Risk Council do—because you say here—and obviously I think this is an important possible area of some common ground—you say, "The Systemic Risk Council would be authorized then to monitor the worldwide financial system, report to Congress and the public on the possible growth of systemic risk, or the factors that might produce a serious common shock."

Would they have any more power than just to report it to us? Do they just drop it in our laps? Or would you give them any power to do anything other than limiting the capital limits on banks?

Mr. WALLISON. Well, I outlined in my prepared testimony some things in addition that they might do.

The CHAIRMAN. I didn't find any formal things. Help me with it, because I couldn't find any, other than there was a metrics of risk-taking.

But the Systemic Risk Council identifies, as you say, the growth of systemic risk factors that might produce a serious common shock—would they be empowered to do anything about that?

Mr. WALLISON. The most important thing that the Systemic Risk Council would do, Mr. Chairman, is to identify areas that were not identified before the current crisis—

The CHAIRMAN. And would they be empowered to act on that, once they had identified it?

Mr. WALLISON. I think the way it would work is that they would instruct the supervisors of the particular institutions. The members of the Council would be the Federal Reserve, of course, the OCC, the FDIC, and so forth. And when the Council saw that there was developing the kind of systemic risks that we have had up to now, which is all—

The CHAIRMAN. Let's talk about what they would do. They give instructions to the regulators. Would they be binding on the regulators?

Mr. WALLISON. I would expect that the regulators would take those actions—

The CHAIRMAN. Well, then we have to write laws. We can't do attitudes. I don't mean to be, you know, pressuring you too much. But I have to write a law here.

Would the Systemic Risk Council have the power to order the regulators to act, once they have discovered something? Or would they not?

Mr. WALLISON. Well, I don't think it's possible to order regulators to do anything—

The CHAIRMAN. By statue—

Mr. WALLISON. But if they have agreed to the Council's policies—

The CHAIRMAN. I'm going to stop you here. You could statutorily say that the Systemic Risk Council had the statutory authority to require action. Of course you could. It's a question of whether you want to or not.

Mr. WALLISON. Well, the regulators are part of the Council, Mr. Chairman. I don't understand how—

The CHAIRMAN. Does the Council have to vote by unanimous—

Mr. WALLISON. What the Council decides to do—

The CHAIRMAN. Does the vote have to be unanimous on the Council? No.

Mr. WALLISON. I think that's the sort of thing a Council can decide on its own. I haven't run into those kinds of questions—

The CHAIRMAN. Well, I'm going to say I'm disappointed, because you're leaving ambiguities here that are not—I'm sorry, Mr. Wallison, I'm going to finish—that are not appropriate to a statute.

So can the fact that one member, one entity as a member of the Council doesn't mean that it might not be in disagreement. And I think you'll leave yourself hanging here when you say we have this Systemic Risk Council and they can report, monitor the growth of systemic risk or the factors that might produce common shock. And then you leave me hanging as to what they do about it.

The gentleman from Texas?

Mr. HENSARLING. Thank you, Mr. Chairman.

My first question for anybody on the panel who would care to take it is as you analyze the root causes of the economic turmoil we find ourselves in today, I am curious what aspects of the turmoil you can cite as resulting from a lack of regulatory authority as opposed to perhaps mistakes, malfeasance on the part of regulators.

Clearly, we have a very large capital markets reform bill in front of us. Some have opined that we had a lack of regulatory authority. I am not sure with the exception of Fannie and Freddie, we have covered that history and battle before, but with that possible exception, I know for example we had testimony from the head of OTS that he had the resources, the financial expertise, the regulatory authority to regulate the credit default swaps of AIG, they just missed it.

As we analyze the legislation before us, is it more regulatory authority that we need? Do we need to make sense of the regulatory

regime we have before us, or do we just need to figure out a way to get regulators to act smarter and perhaps focus on systemic events that previously they have not focused on?

Whomever might want to take that first. Mr. Johnson?

Mr. JOHNSON. Mr. Hensarling, I think I completely agree with you on the safety and soundness point, which is that the regulators did have the ability, did have the statutory authority to reign in many of the excesses, including to prevent the abuses of consumers that we have seen, and they did not exercise those powers.

That is part of the reason, I think, we should actually reinforce the protection of consumers through a new safety agency, focused just on consumers.

I think with regard to banking safety and soundness, on derivatives, perhaps the regulators could have found the authority, but I think they were correctly interpreting the legislators' intent with regard to not regulating many derivatives' transactions, and I think that was a very conscious decision made at the end of the 1990's, which should be re-visited. I think putting that in the legislation makes sense.

Mr. ZANDI. Can I take a crack at it?

Mr. HENSARLING. Sure, Mr. Zandi.

Mr. ZANDI. I think that the reason why this financial crisis evolved into a financial panic last September—I think it was a manageable, albeit greater than garden variety crisis prior to September, it turned into a panic in September because policy makers, including the regulators, the Federal Reserve, the Administration, did not have a clear understanding of what their authority was and how they should use it.

That begins with Fannie Mae and Freddie Mac in early September. That extends to Lehman Brothers. That extends to AIG. That extends to Citigroup.

I think that goes to a key failing of the current regulatory structure.

Mr. HENSARLING. I have limited time. Let me move onto another line of questioning here. To me, a very fundamental question that we have to examine here is if we either implicitly or explicitly designate firms as being systemically significant, do we not have a self fulfilling prophecy?

I am trying to figure out how does one avoid that. If you set up criteria for bank holding companies, there is so much public information there, if you attempt to keep these firms confidential, their names, sooner or later, the market is going to figure out which firms have the implicit guarantee and which do not.

We know with Fannie and Freddie how implicit becomes explicit at the snap of a finger and hundreds of billions of dollars of taxpayer exposure/liability later.

I just do not understand any mechanism that one steps up, and I appreciate the argument that regulators need to look at individual firms and that through capital and liquidity requirements, maybe there is much they can do to reduce the systemic risk, but once you set up a criteria, I do not know how you do not have a self-fulfilling prophecy and everybody is waiting in line wanting to be the next systemically significant firm. I just do not see how you avoid it.

Mr. Wallison?

Mr. WALLISON. It seems to me if we focus solely on the banking industry, we do not have that problem because all banks are regulated. Right now, the largest banks are regulated much more fully than the smaller institutions.

One can assume that a large bank is too big to fail, but it does not have to be true. There is a certain amount of ambiguity when you come to a line between the very largest and the less large institutions.

We have no idea what systemic risk is. That is one of the major faults in this legislation.

What we ought to do is simply make sure that the banking industry is safe and sound and then we do not have to worry about any of the others.

The main fault with what the Administration is doing is attempting to extend regulation which did not work for the banking industry across a broader range of our financial system. There is no need to do that. If we focus solely on banks, we can solve almost all of the problems that we encountered in 2007 and 2008.

Mr. HENSARLING. Thank you. It is up to the chairman. I see I am out of time, Ms. Rivlin.

The CHAIRMAN. The gentleman from Pennsylvania.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Ms. Rivlin, in your testimony, I am not sure I understood whether or not you were indicating that the Federal Reserve should not be designated as the systemic risk regulator or that it was in fact well qualified to be the gatherer of information and data for the systemic risk regulator.

Ms. RIVLIN. I was trying to distinguish two concepts of systemic risk agencies. One is monitor and gatherer of information for which I think the Fed is very well qualified and should be doing it anyway and it is coordinate with its responsibilities on the economy. I would put that responsibility there.

I do not think that it should be the systemic risk regulator in the sense of regulator of systemically important institutions, regulator supervisor of systemically important institutions, because (a) I do not think there should be such a designated responsibility for the reasons we have been talking about. I do not think you should have a list.

Second, if you did do that, I sure would not put it at the Fed. I think it would dilute their monetary policy responsibilities and they would not be very good at it.

Mr. KANJORSKI. I agree with you, but I wanted to perhaps attack part of your premise there. I recall very clearly in 2005, the Chairman of the Federal Reserve was testifying before this committee.

I specifically asked him a question, whether or not there was a real estate bubble in his opinion, and he said he thought there was, and that the price of real estate was ever increasing, but it was perfectly manageable and it did not constitute a risk to the system.

If he in fact were the gatherer of that information and the analyzer of that information, we would have missed the opportunity to have found systemic risk.

What is your answer to Mr. Greenspan's lack of perceiving that difficulty?

Ms. RIVLIN. I think he was just wrong. He said that himself. He did not see this one. I think we have learned a lot about bubbles.

One thing we have learned is that interest rates is not a perfect tool for controlling them, which is why I would give them more leverage control as well.

Mr. KANJORSKI. I understand that. Let me move to Mr. Wallison because you seem to be talking about that our only problem here in regard to systemic risk exists in financial institutions.

Mr. WALLISON. No. I think the only real problem exists with banks, commercial banks.

Mr. KANJORSKI. Just banks, nothing else?

Mr. WALLISON. Just banks.

Mr. KANJORSKI. Mr. Wallison, testimony before this committee not too many months ago was heard from General Motors, Ford and Chrysler. They appeared together, their CEOs, and I think the CFOs of those three corporations.

Their testimony was quite clear that it was their opinion that the failure of any one of them, and particularly Chrysler, who only entertained 7 percent of the car market in the United States, would cause systemic risk if they were allowed to fail, and that was their opinion as to why the Congress should marshal the assets necessary to "bail" the three companies out if they needed it, but most particularly Chrysler and General Motors, who at the time did recognize the fact that they needed it.

Their total argument was that they both feed off the same dealer base and supplier base. Just the loss of Chrysler Corporation's 7 percent penetration of the market and the use of the dealers and suppliers would bring down all of the suppliers and all of the dealers, and therefore bring down the entire industry.

Just recently, on Friday, you probably have read the paper, the question that I would pose to you, I want your idea on the General Motors' problem, but then CIT, most of our regulators concluded that did not constitute systemic risk, I think that is the conclusion. Luckily, they did not need help from the Government ultimately.

As I understand the problem, as it was explained to me on Friday, if it had been allowed to fail, that is the factory business that CIT was involved in, that it would have brought down 70 percent of the apparel suppliers in the country, to the extent that the department stores and specialty stores in the retail business in the United States would not have had the inventory to continue their practices.

Hundreds of thousands if not several million jobs would be lost in the supplier trade manufacturing and in the retail businesses throughout the country.

That came to my attention through a department store owner who called those facts to my attention.

Would you not feel that perhaps is a systemic risk and it is not a financial institution—

Mr. WALLISON. In my testimony, Congressman, I looked very carefully at this question of the difference between a systemic risk and mere disruption.

We really do not understand what systemic risk is or how it would be created or what kinds of institutions would create it. This

is one of the fundamental problems with what the Administration is talking about.

In the case of General Motors or Chrysler or Ford, for that matter, or CIT, yes, there would certainly be disruption if a large firm fell. I think the same thing is going to be true of financial institutions other than very large banks.

That is why it is such a bad idea to provide to the government the authority to bail out or take control of any kind of institution, because the institutions will always come in and argue that their failure will cause some sort of huge loss in our economy, whereas in fact companies fail all the time. But they don't create a systemic event, just disruption. They get worked out in bankruptcy. Sometimes, they return to full activity. Other times, they are completely unwound.

We have to make sure that we know the difference between a mere disruption, which they will claim, and a systemic risk. We do not know how to make that distinction.

The CHAIRMAN. The gentleman from Alabama.

Mr. BACHUS. Thank you. I read something here for the first time. I agree with it. I have thought it. It is from Mr. Johnson, who actually was called by the Democratic Majority to testify.

What he says are short-term measures taken by the U.S. Government since the Fall of 2008, particularly under the Obama Administration, have helped stabilize financial markets, primarily by providing unprecedented levels of direct and indirect support to the large banks.

But these same measures have not removed the long run causes of systemic instability. In fact, as a result of supporting these leading institutions on generous terms, systemic risk has widely been exacerbated.

In other words, the bailouts have actually increased the danger.

Mr. Wallison, that is similar—you have said that in a different way, have you not? That we actually are creating a more dangerous environment?

Mr. WALLISON. Yes, of course. Every time we bail out one institution, we create the belief on the part of people in the markets that other institutions that have a similar size or maybe even smaller will also be bailed out, and as a result, great moral hazard is created, as Professor Mahoney made so clear in his testimony.

Mr. BACHUS. Mr. Kanjorski and I were at a meeting with one of the leading hedge fund managers. I will not name his name. The Financial Times said he was the smartest billionaire in the world. He said the same thing you said about Lehman in your testimony.

The problem was the markets were shocked. They thought they were going to bail them out because they had bailed out Lehman, which is exactly what you said. I am not sure if you were aware. This gentleman is a very private individual. You all came to the same conclusion.

Mr. Johnson goes on to say, and I believe this is absolutely true, some of our largest financial firms have actually become bigger relative to the system and stronger politically as a result of the crisis. The competition has been eliminated.

Do you agree with that, Mr. Johnson?

Mr. JOHNSON. Yes, sir.

Mr. BACHUS. Executives of the surviving large firms have every reason to believe they are too big to fail. They have no incentive to help bring system risk down to an acceptable level. That is exactly the problem we have today.

Mr. Johnson goes on to say that when you have a situation like this, it is either bailout or collapse, but as it begins to affect other institutions, responsible official thinking shifts to bailout at any cost. We certainly have seen that over the past 6 months.

Mr. Zandi says, and here is where I think we maybe can all come to a consensus, he said the Treasury and the Fed were seemingly confused as to whether they had the authority or ability to intervene to forestall a Lehman bankruptcy and ensure an orderly resolution of the broker-dealer's failure. The procedure was not in place.

Mr. Mahoney today has said give them that procedure, as I understand it. Give them a procedure, but in bankruptcy.

Is that right, Mr. Mahoney?

Mr. MAHONEY. That is right. I think the idea of adding another chapter to the Bankruptcy Code makes perfect sense. It is probably the case that the amount of agenda control that debtors have in the standard Chapter 11 bankruptcy proceeding could be disruptive in the case of a large financial institution where you are dealing with some short-term creditors who need to know what is the value of this obligation that I am holding sooner rather than later.

I think you could create a quicker, more streamlined procedure. I would draw a sharp distinction between the procedure through which this happens and the substantive rules that will govern it.

I think it is important that the substantive rules be the same as they would be for anyone else, which is to say the creditors take their losses in the order of their contractual priority so it is predictable. There is a set of rules that is known in advance, and everyone will understand where they are in the pecking order.

Mr. BACHUS. Mr. Zandi, you said the confusion is the big problem, but if we had the substantive rules that we used in dreadful WorldCom and Lehman, ultimately, you would clear up the confusion. You would have certainty, and the certainty would be that they would go into—you would have an expedited procedure, and you can call that expedited bankruptcy, but it really needs to be there, in my opinion.

Mr. ZANDI. I think the Bankruptcy Code probably would be inadequate for purposes of these kinds of failures.

Mr. BACHUS. If we made the procedure, if we changed the procedure—

Mr. ZANDI. I do not think the courts would be viable for the kind of decision-making that needs to be done as quickly as needs to be done.

Mr. BACHUS. We had a small bank in Washington fail and the FDIC put 400 people on it. Obviously, they would need help from the regulators. I would agree with that.

Mr. ZANDI. To me, too big to fail is more than the interconnectedness of the institutions, it also goes to the confidence we have in our system. You would get bank runs, and if you go into a bankruptcy proceeding, you may be able to solve the interconnectedness problems, but confidence would still be an issue.

Mr. BACHUS. Of course, you said about the regulators that we all know they had a complete lack of understanding.

Mr. ZANDI. And that needs to be changed, but I do not think the Bankruptcy Code is the way.

Mr. BACHUS. I do not know how you give understanding. That is worse than the bankruptcy courts to me. If you gave them the procedure, you gave them a right to do things, and you establish a procedure, maybe we can work together on some things, how we could amend that Code and use the basics.

The CHAIRMAN. The gentlewoman from New York. May I ask the gentlewoman to yield me 1 minute? I did want to respond.

Reading Mr. Johnson's point here that short-term measures, particularly under the Obama Administration, I am not sure entirely what he means. I do want to be very clear.

Every single activity now characterized as a bailout that is going on in the United States was initiated by the Bush Administration, by Mr. Bernanke and Mr. Paulsen. That is AIG, Bear Stearns, Merrill Lynch, and Bank of America, which was kind of a bailout. That was General Motors, Chrysler. Every single one of them.

The first proposal for a bailout that came to the Obama Administration was CIT, and they said no. Literally, every single bailout now going on was initiated in the Bush Administration for the Obama Administration to carry out.

Yes, it is true, I agree, I think we all agree that where we are today is a result of the need for the bailouts and then the bailouts have made us more vulnerable. That is why our agenda is to try to do something about it. That is no great point.

Sure, we need to do something, but again, there is not a bailout underway today that was not initiated by the Bush Administration.

I thank the gentlewoman. The gentlewoman from New York.

Mr. BACHUS. Mr. Chairman—

The CHAIRMAN. It is the gentlewoman from New York's time.

Mr. BACHUS. You took the extra time.

The CHAIRMAN. I asked the gentlewoman to yield. This is the second time the gentleman has done that. I have asked other members to yield. It is disruptive. I have asked members to yield. I would ask the gentleman to pay attention.

Mr. BACHUS. I will be less disruptive in the future.

[laughter]

The CHAIRMAN. The gentlewoman from New York.

Mrs. MALONEY. Thank you, Mr. Chairman. I truly believe that our government was at its best following the 9/11 crisis, when we came together and created a bipartisan professional commission to study exactly what went wrong.

They came forward with a professional report that sold more copies than Harry Potter. It pointed out 53 direct areas that they thought needed to be corrected.

We then proceeded to react to their recommendations, and this Congress passed 47 of their recommendations.

I do not believe that we were aware of what the true problems were until we got that report.

I for one would like to see the report coming back from the bipartisan commission on what really caused this crisis, and their ideas

of what we need to do to reform our system and to go through that process.

We now have a blueprint that in many ways looks like the problems that we confronted. Many people say Fannie and Freddie with their implicit government guarantee caused many of the problems.

What are we going to come back with? An implicit guarantee that tier one too-big-to-fail banks are going to be guaranteed. Therefore, everyone is going to want to do business with the guaranteed bank, and every bank is going to want to be a tier one in order to have that implicit guarantee that gives them an advantage in business, lower rates, more prestige.

I am not so sure that is the direction we want to go in. Then the other idea is that we have a systemic risk regulator under the Federal Reserve. I would argue we have a systemic risk regulator now under the Federal Reserve. They have tremendous power to look anywhere they want.

The prior Administration before Mr. Bernanke was criticized for never having taken a step on the subprime crisis, never coming forward with a directive, never pointing out what needed to be done. I am not so sure a systemic regulator, which is very much dependent on the ability and drive of the person in the position, is the exact answer to our problem.

The only thing that we seem to totally agree on is that regulation failed, yet the regulation they are proposing is very similar to the regulation we already have right now.

I would build on really a question the chairman brought up earlier, what happens when you disagree? When we have this council of regulators and they disagree, how do you come to the conclusion?

Many people say Lehman brought down the stability of our financial sector in many ways. Where was the way to counter the decision of whomever made that decision? How would you agree with these councils?

You have to have a specific way that you agree because you know they are going to disagree. I see it every day. There was tremendous disagreement recently over how to respond to other challenges in the private sector with various businesses that was played out in the press.

My time has expired.

The CHAIRMAN. Brief response? Mr. Johnson?

Mr. JOHNSON. I agree completely with Mrs. Maloney. I think you have to assume that regulators will fail in the future as they have failed in the past, and you have to assume that extending any kind of implicit guarantee is going to create the same sort of distortions and problems as in the past.

I think you need to design the system around those assumptions, and to my mind, making the largest institutions, financial institutions, smaller, is not a guarantee by any means against future problems, but it means when the problems occur, they should be more manageable. You should be more able to push them down to the bankruptcy courts.

Still, sometimes it is going to be very hard to predict. Sometimes government may need to take actions. You need to make sure they have the appropriate authority to do that.

The CHAIRMAN. The gentleman from New Jersey.

Mr. GARRETT. Thank you, Mr. Chairman. Before I begin, let me associate myself with the words of the gentlelady from New York on just about everything she said. That may be a first, but I do.

Mr. Zandi, if I heard you correctly, and correct me if I am wrong, we need a systemic risk regulator and you advise it to be in the Federal Reserve?

Mr. ZANDI. Yes.

Mr. GARRETT. You need someone to address situations, future asset bubbles, for dealing with being countercyclical as opposed to being procyclical?

Mr. ZANDI. Right.

Mr. GARRETT. Also, someone who can address maybe on the regulatory side, capital requirements as well; is that correct?

Mr. ZANDI. Yes, they would have authority there as well.

Mr. GARRETT. You would put it in the Federal Reserve. The reason why I want to clarify that is if you look at the history of the Federal Reserve on each one of those points, you have to raise the question, why them? On the asset bubbles, someone else raised a question to Ms. Rivlin with regard to the housing bubble that we had, I am going back even further than that with the tech bubble.

Alan Greenspan later on said maybe I missed that one and he sort of re-wrote history, some would say, as far as his review, whether he knew about that or not, but if you look at the minutes of the Federal Reserve, not just him but the entire Federal Reserve, they all missed that. There was no discussion whatsoever with regard to an asset bubble during the entire time. They were looking at it purely as an increase in productivity.

On the countercylical aspect of it, the Federal Reserve was out front for a long time on Basel II; were they not? Which would go in the wrong direction with regard to that.

As far as on the capital requirements, did not the Federal Reserve have the ability with regard to institutions under them, Citi and Bank of America, and did they do anything? The answer is no, regarding raising capital requirements.

Here is an entity that you are nodding your head to, with a "dismal" track record in each one of those, but you, sir, would suggest they are the ones we are going to give the authority to.

Mr. ZANDI. Right. If I were king for the day, I would design it differently. I would think that a model where the regulatory function was in a separate entity, that was a systemic risk regulator that was separate from the Federal Reserve would make the most sense.

I think in the context of where we are starting from and just the practicality of the situation, I think the most logical place for that to reside is the Federal Reserve.

Mr. GARRETT. Of all the bad choices that are out there, they are the best one?

Mr. ZANDI. Exactly; right. I do think there was a general philosophy, maybe even to this day, that the Federal Reserve should not weigh against asset bubbles, that is not in their job description, so to speak. I think that is inappropriate.

I think that it should be something they should do and the tool that they need to implement that—

Mr. GARRETT. It is not in their rules that they should be weighing in with regard to asset bubbles?

Mr. ZANDI. No. There is a reluctance to weigh against asset bubbles, yes, at the Federal Reserve.

Mr. GARRETT. Before you can even weigh into them, you first of all have to see them.

Mr. ZANDI. That is probably why they have a reluctance to do that.

Mr. GARRETT. And they did not see them.

Mr. ZANDI. My view is bubbles are created largely by leverage, that if they have a very clear ability to control or manage leverage throughout the entire financial system, which they would have as the systemic risk regulator, then they would have the tool they need to be able to manage that aspect of monetary policy.

Ms. RIVLIN. May I?

Mr. GARRETT. Sure. You are where I was going next.

Ms. RIVLIN. I think there is a difference between the bubble in the 1990's in the stock market and the housing market bubble.

I was at the Fed in the 1990's. We did not miss the stock market bubble. We knew it was there. We talked about it. Mr. Greenspan made the speech. We did not do enough about it, in my opinion. We could have raised margin requirements. It would have been largely symbolic, but we should have done it.

We did not have the right tool. Raising the short-term interest rate in the middle of the bubble, we also had the Asian financial crisis and a lot of other things going on, so you do not have the right tool if you are relying entirely on the short-term interest rate.

Mr. GARRETT. Mr. Wallison, I thought you were going to say a quick no to the chairman's question in regard to the policy, this council being able to tell the regulators what to do. I thought you were saying no, they cannot do that.

Do you have another comment to make?

Mr. WALLISON. Yes. I have a comment on the question of bubbles. I think we have to distinguish this bubble from every other bubble. We will always have them. We are human beings. We tend to believe that when things are going in one direction, they will continue to go in one direction. That is both up and down.

This bubble was completely different. In this bubble, we had 25 million subprime and non-traditional loans that are failing at rates that we have never seen before. The question we have to answer is, why did that happen? That is one of the major reasons that this particular bubble turned into a worldwide financial crisis.

Mr. GARRETT. Thank you.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman. Ms. Rivlin, I confess I am having a little trouble understanding what you would do. You talk about a "macro system stabilizer" and then you talk about a "systemically important" or somebody who is over—I thought that what you were proposing was akin to what the Obama Administration has proposed, that the Fed be put in charge of the kinds of things that you indicate a "macro system stabilizer" would do, but you seem to have some concerns about that. Can you clarify what it is you are proposing?

Ms. RIVLIN. Yes. I am proposing the exact opposite of what the Obama Administration is proposing. We both recognize that there are two kinds of tasks here. One is spotting problems in the system that might lead to excessive boom or a crash.

Mr. WATT. Okay, and they propose, the Administration proposed to give that to the Fed?

Ms. RIVLIN. They propose to give that to a council. I would give it to the Fed because I think it is very similar to the kind of responsibility that the Fed has already to spot problems in the economy.

Mr. WATT. And if one of those spot problems was that one of these institutions' interconnectedness is an issue, would you not give the Fed the authority to deal with that?

Ms. RIVLIN. I would not.

Mr. WATT. Who would you give the authority to deal with that?

Ms. RIVLIN. I think we need a new regulatory institution to be the consolidated regulated of financial institutions. I would not separate out the too-big-to-fail ones and give them a special regulator.

Mr. WATT. But that should not be the Fed, is what you are saying?

Ms. RIVLIN. And I certainly would not have the Fed do that. I do not think they do—

Mr. WATT. So you would create a new agency for that purpose?

Ms. RIVLIN. Ideally, I would. And I think that that—

Mr. WATT. We are getting quite a bit of push back from the proposal to create a new agency for consumer protection. Would you create a new agency for consumer protection too?

Ms. RIVLIN. I would let, but let me explain what I meant on the first time. I would consolidate regulation of institutions, financial institutions, into a single regulator, ideally. I would not separate out the too-big-to-fail ones from the other ones.

Mr. WATT. So this new agency would be—would have the responsibilities of all of the existing regulators plus some others?

Ms. RIVLIN. Yes, so you would un-make a bunch of agencies. I did not stress that in my testimony because what I wanted to stress was not doing the too-big-to-fail institutions separately and not putting that at the Fed.

Mr. WATT. Would this big new agency have responsibility for the institutions that might be too big to fail?

Ms. RIVLIN. Among others.

Mr. WATT. So you would put that under their jurisdiction?

Ms. RIVLIN. Well, but I would not have a separate list.

Mr. WATT. Oh, yes, okay. You did not tell me what your opinion was on the consumer protection agency. You did I guess, but you did not tell me why?

Ms. RIVLIN. I think a new consumer protection agency would be a good idea because the existing agencies have not performed this function well. And you can either make sure that they perform it well, the Fed did not, for example. Or you can put it in a new agency. At the moment, I think I would opt for a new agency.

Mr. WATT. All right, I thank you, Mr. Chairman. I yield back. I just wanted to get clarification.

The CHAIRMAN. Will the gentleman give me 30 seconds? Ms. Rivlin, how much time when you were at the Fed did you spend on consumer issues?

Ms. RIVLIN. It depends on what you mean by that. We spent quite a lot of time on—there were consumer councils who advised on whether TILA and so forth were being—

The CHAIRMAN. Credit cards, home mortgages, unfair and deceptive practices?

Ms. RIVLIN. Yes, not very much. I do not think the Fed did that well.

The CHAIRMAN. Yes, thank you. No, I did not mean you personally. The gentleman from Texas?

Mr. MARCHANT. Thank you, Mr. Chairman. Mr. Wallison, I saw you on a TV program this morning, and you made a comment that I would like you to follow-up a little bit about. You said that AIG actually was not too big to fail. Am I misinterpreting that?

Mr. WALLISON. No, that is right.

Mr. MARCHANT. And that there was actually no default there, no actual default on the part of AIG?

Mr. WALLISON. I think we were talking at that time about credit default swaps.

Mr. MARCHANT. Yes.

Mr. WALLISON. And a credit default swap is, in shorthand, like an insurance policy. You are insuring someone against a loss. My point was simply that when AIG failed, it did not cause any losses to any of the people who were its counterparties. It is just exactly like you have an insurance policy on your home, and your insurer fails. You would go out and get another insurer, but unless you had already had a fire, you had not suffered a loss.

And that is exactly the case with credit default swaps. There is in my view a lot of misinformation around about credit default swaps, suggesting that they are very dangerous. I do not believe they are dangerous. And I do not believe in the case of AIG there was any need to bail out AIG. AIG had one major counterparty, and a lot of others, but the biggest one was Goldman Sachs, $12.9 billion in credit default swaps, with which AIG was protecting Goldman Sachs. When it was learned that Goldman Sachs was in fact the major counterparty, the press went to them and said, "What would have happened if the government had allowed AIG to fail?" And Goldman Sachs said, "Nothing, we were fully protected. We had collateral from AIG. And, in addition, we had bought other protection against a possible failure by AIG. So it would not have been a problem for us." And that I think is how we have to look at the AIG question. It was large. It was engaged. It was interconnected, as all financial institutions are always interconnected, but the possibility of loss from AIG was very small.

Mr. MARCHANT. Mr. Zandi, would you comment on the fact that this last bubble was created in large part by financial instruments that did not exist maybe 20 years ago, and especially the derivative part of the mortgage part of it, and how it sustained a bubble in the housing market, which really sustained the mortgage market, which continued to sustain the housing market?

Mr. ZANDI. Well, I think one of the root causes of the bubble in the housing market was that the process of securitization was fun-

damentally broken, that no one in the chain of the process had a clear understanding of all the risks in its entirety. The lenders made the loan. They sold it to the investment banks. The investment bank's package got the rating. The rating agencies then put their stamp on it. And then it was sold to Goldman investors. And no one was really looking at the entire system, making sure that the structure was properly working, that the loans that were ultimately being made were good loans. So the process of securitization fell apart. It just was not functioning well because in my view there was not a systemic risk regulator looking at it holistically and saying, does this make sense, and will it work if it is stressed under a bad economy, under a bad housing market?

Mr. MARCHANT. And it was a product that really was unfamiliar to anyone who was looking at it, even its regulator, even a lot of the regulators?

Mr. ZANDI. I do not think anyone truly understood the entire process altogether. I think the process of securitization I should say has economic value and it makes sense under certain circumstances, but that got abused and the economic value got lost in the profit-making that was going on during the period.

Let me just say I do not agree with AIG. I think it is very clear that if AIG failed, it would have been a very substantive risk to the entire financial system and the economy. And this goes to an important point. We talk about too-big-to-fail in the context of relationships, in the case of AIG, credit default swaps, but it also goes to confidence. That you have to remember back to that day in mid-September when AIG was about ready to go under, confidence was completely eviscerated, and if that institution failed, a lot of other institutions in the entire system and the economy would come to a grinding halt. So I do not agree with that assessment.

Mr. MARCHANT. Thank you, Mr. Chairman.

The CHAIRMAN. We are going to break now. And let me say this, votes will probably take 35 to 40 minutes, and then we are taking our picture. I plan to come back. I am going to skip the picture. And if other members want to come back, we will start again. I do not want to impose—if you can stay, we would appreciate it. Obviously, you have a right to leave. But if anybody can stay, I plan to be back in about a half-hour and any other members who are here, and we will do some more questioning for another 45 minutes or so after that if that is acceptable. Again, I will understand if you have obligations and do not want to sit around while we have our picture taken. We are in recess.

[recess]

The CHAIRMAN. I am going to recognize myself for another round, and I will recognize other members. But this has been very useful. One important question, and I must tell you this is partly a hearing, as I said, to learn things, but it is partly to refute things. There is out in the country a frustration about the fact there were bailouts and anger about too-big-to-fail. I think there are some people who think it is easier to do than others. Of course, one obvious answer that you get from some people is, if something is too big, what do you do? You make it smaller. And one of the things I want to be clear about, and Mr. Wallison, although he is not with us, already made this clear, several of you said there were ways to re-

strain growth by a higher capital charge that is disproportionate by insurance levies. So we understand that. And I think there was a general consensus that things that would restrain growth could be very helpful. Does anyone on the panel favor either an absolute limit on growth or even beyond that, reducing the size of existing institutions? And I ask you that because that is a very important view that is there. And when people say, "Gee, you do not want it too-big-to-fail, make it smaller, keep it small," let me go down the line, what is your response to people who say, "Hey, if it is too big, make it smaller or keep it small?" Ms. Rivlin?

Ms. RIVLIN. I do not think there is a feasible, defensible way to break up institutions, so my answer to that would be no, but discourage growth.

The CHAIRMAN. Right, but you would not put a cap, a legal cap on it going forward?

Ms. RIVLIN. No.

The CHAIRMAN. I know, Mr. Wallison, that we have already discussed that. Mr. Johnson?

Mr. JOHNSON. I would favor a cap certainly in the interim until you feel that these restraining measures have bite. As you pointed out, Mr. Chairman, at the beginning, we would have a cap I guess on the books.

The CHAIRMAN. At 10 percent.

Mr. JOHNSON. Yes, exactly. And the rationale behind that presumably is it is not antitrust because we have a different mechanism looking at that, it is sort of a back-up, it is a fail safe.

The CHAIRMAN. You are right because I do not know of an antitrust regime in which 10 percent gets you into the anti-competitive situation.

Mr. JOHNSON. Not usually.

The CHAIRMAN. Except the way some of us feel about people who run against us but other than that. What would the cap be, what could you cap as an interim?

Mr. JOHNSON. Well, I think—we do not have perfect information on this, but I think that the Treasury itself identified 19 institutions that they thought were systemically important and therefore subject to stress tests. That is on the one hand. On the other hand, we see the experience of CIT Group, which is just one data point but it is extremely informative because in terms of the arguments they were making about being interconnected, their importance to the real economy, there were all kinds of arguments about how they are widely cited synthetic CDOs, I think that all turns out to be baloney. They are not that systemically important. You can let them fail through bankruptcy or renegotiating with their creditors. So that says the threshold is somewhere between $100 billion total assets and $500 billion total assets, subject to a leverage caveat, Ms. Rivlin, right? You have to—

The CHAIRMAN. But that is assets? What is the cap? We know we have one on deposits and that is a percentage one. What would be—the metric be, would it be assets?

Mr. JOHNSON. Yes, well, it is assets, it is either total dollar assets or it is assets as a percentage of GDP. So I am saying 1 percent of GDP total assets would be the CIT threshold.

The CHAIRMAN. Wachovia failed, Countrywide failed. They were pretty big. It did not cause the skies to drop because we had a regime. Mr. Zandi, what is your sense of this?

Mr. ZANDI. I think it would be very difficult and counterproductive to try to break up private institutions. I do not think that makes a lot of sense. I think it makes a lot of sense to raise the cost of being large and larger, and I do not think there needs to be any cap at all. As you get larger, you pay more because you are relying on the system in a more significant way.

The CHAIRMAN. And I assume the rationale for that is that if you raise capital, reduce leverage, particularly in a kind of disproportionate way, you are making failure both less likely and less costly if it happens?

Mr. ZANDI. Exactly, also I think you might want to also in addition to capital ratios or leverage ratios, the deposit insurance fee or another insurance premium so that you are self-insured.

The CHAIRMAN. Mr. Mahoney?

Mr. MAHONEY. I would not agree with a cap. I think there are ample small- and medium-sized banks that could compete effectively with the large banks if they are on a level playing field. And the problem is they are not currently on a level playing field because there is one group that has this implicit guarantee and there is another that does not. You would do away with that.

The CHAIRMAN. I appreciate that. Let me tell you as an economic historian, as to the level playing field, no entity in the economic history of America has ever been on the high end of the level playing field. I know economists have concepts about constantly downward sloping things, we have a constantly downward sloping playing field. I have been doing this for many, many years, and I have heard the playing field invoked several times and never has anyone ever been at the top of it. It is an extraordinary playing field in which everybody is at the bottom. It is the reverse of Lake Wobegon. Everybody is way below average.

But I appreciate that. And I guess what I am saying is to the extent that it is a too-big-to-fail issue, it is not anti-competitive, and so that is why antitrust—people raise about antitrust. The problem is not anti-competitive; it is the negative impact of failure.

Let me just ask Mr. Johnson, it is important to sort this out, would it be the prudential regulator of each institution? I know Mr. Wallison only talks about banks. Others I think did not think it would be limited to banks. Who would say when the time had come to put the cap on? Would it be the council or the individual regulator? Mr. Johnson, you are the only one who wanted a cap so I ask you?

Mr. JOHNSON. I am not a big council fan myself and not really endorsing that, but I think it has to rest with whomever has the authority to do the bailouts. Who makes the bailout versus collapse decision? It is Treasury under our system. I think it remains Treasury because they write the checks.

The CHAIRMAN. I think that is a good point. And I know your prior history at the IMF. I understand your aversion to the conciliatory form of governance. I am sure it was a trial from time to time.

Mr. Royce?

Mr. ROYCE. Thank you, Mr. Chairman. I would ask a question of Mr. Mahoney and Mr. Zandi for their opinion on this. For many years I was concerned about the perceived government-backing of Fannie Mae and Freddie Mac and about the ability of these firms to borrow at interest rates that were a lot lower. They were near governmental rates. And most private companies of course because of perceived investment risk associated with Fannie and Freddie being so much lower, most of their competitors were at a disadvantage. At the same time, they were allowed to involve themselves in arbitrage. I think the leverage was 100 to one.

I think that one of the main problems that we had was legitimizing the idea that subprime loans were safe. And I think the fact that the Government-Sponsored Enterprises went out and purchased for their portfolios a half trillion of these, directed by the government to do so, by the way; and one of the comments made by one of the GSE officials was that we sought to indicate to the market the safety of mortgage-backed securities that were subprime.

And I do think that that entire process, and the way in which they became a duopoly, forced their competitors out, became too big to fail, there is a probably a lesson we should learn out of that. And I think it would be very dangerous for Congress to move to set up a regulatory structure that separates these institutions that are deemed systemically significant from the other institutions, whether you do that de facto or de juri, whether you name them or you do not name them. The result I suspect is likely to be the same. There will be the perception that these particular institutions are going to be covered. So how will the market perceive these companies, and are you concerned that counterparties will then perceive their investment risk in these institutions would be a lot lower and therefore it starts the process of being able to overleverage. It starts the process certainly of having a lower cost of capital, which will force your competitors out of the market. What will this mean for institutions competing against these now government-backed companies that in essence become too big to fail and Government-Sponsored Enterprises in a way. That would be the result I fear out of it?

Mr. MAHONEY. Well, I agree with that point entirely. I think that the counterparties of that entity are going to—all other things being equal, want to deal with a so-called tier one entity because they will see that it has the implicit guarantee. Whether you call that a competitive advantage or simply point out the fact that those entities are likely to increase in size, I think they will increase in size because they will be the most attractive entities to do business with. So if your objective is to limit size, I think this is exactly the wrong way to go.

I also think that it is probably not a solution to just say we will not identify the entities that are too big to fail. Part of the problem that arose, particularly after Lehman Brothers, was the fear that we could not really predict what the government would do next and what it was going to do was going to be quite ad hoc, and this in some sense enshrines an ad hoc and unpredictable process.

Mr. ROYCE. Let me ask Mr. Zandi for his observations on those two questions?

Mr. ZANDI. Yes, I sympathize with the concern. I think that at the very least we cannot identify any institution as so-called tier one institutions, too big to fail, because it would lead to some of the concerns that you have enumerated and it would lead to the same kind of problems we have had with Fannie Mae and Freddie Mac.

I do think though, unlike Mr. Mahoney, I think if we do not identify those institutions, and we treat all institutions the same, we say these are the rules, as you grow in size in terms of your asset base and your deposit base, as the composition of your asset base shifts to more riskier assets, than you have to put up more capital, you have to pay higher deposit insurance, you have perhaps another insurance premium to pay in case you do fail, I think that would work reasonably well.

And it is important to remember that Fannie Mae and Freddie Mac were born out of the government and did have a guarantee. They had a line to the Treasury, and none of these institutions that we are discussing today have that similar kind of heritage or that similar kind of backing.

Mr. ROYCE. I will ask one quick last question and that is on subordinated debt, we have talked before, Mr. Zandi, about how we might have avoided this in the past, but what do you think of Mr. Wallison's concept of structuring that subordinated debt, if I could ask you? I do not know if you had a chance to see his paper on that?

Mr. ZANDI. Yes, I read his paper. I do not know it well enough to really comment. I do not have an opinion. I thought it was an interesting idea, but I have not thought it through well enough to really comment.

Mr. ROYCE. Okay, thanks. Yes?

Mr. JOHNSON. Sir, if I could on the subordinated debt and the more general idea that the market can pick up the risk, I would point out that the evidence says the market pricing of risk, for example look at the CDS for Citigroup prior to the crisis, was going the wrong way. They thought Citigroup was becoming less and less risky. As we know, looking back, it was actually becoming more and more risky. So I am afraid, as one thing to look at, it is okay, but as a panacea or something to put a lot of weight on, I would do that with hesitation.

Mr. ROYCE. But basically the way it would work is that the largest banks would be required to issue the subordinated debt, and it could not be bailed out. And so if the interest rate on these instruments were to rise above the rate on Treasury, substantially above the rate on Treasury securities, it certainly would be one signal to regulators that the market perceives excessive risk taking by that bank, and it would then—you could set up a structure so at least there would be an objective way to monitor this, and at the same time you would have the advantage of the subordinated debt out there.

Mr. ZANDI. But why wouldn't you pick up that information in the CDS mark or credit spreads on bonds or even in the equity premium? I am not sure why there is any additional—I do not know.

Mr. ROYCE. But it has the additional benefit at least of having a subordinated debt there that by definition cannot be bailed out.

So it is one more indicator but it is an indicator combined with something that is going to reduce the incentive.

The CHAIRMAN. The gentleman from California?

Mr. SHERMAN. Thank you, Mr. Chairman. Mr. Mahoney, thank you for focusing on the portion of the White Paper dealing with resolution authority. It is being sold as if it is just a tweaking of the Bankruptcy Code, but as you illustrate it is permanent TARP and not limited to $700 billion. It is unlimited TARP. Wall Street will love the money. Treasury will love the power. It has absolutely no chance in that form of passing the House of Representatives on a fair up or down vote. So the question really is whether my party will fall in love of the idea to the point where we try to force Members to vote on it in the dead of night or as part of some major appropriations bill because I think the only thing less popular than TARP in an emergency is unlimited permanent TARP.

The economists here have asked us to design a system that implies the possibility of bailouts, at least as a possibility. And I would hope that whether that is great economics or not, you would recognize the political situation and help us design whatever the best economic regulatory system is that absolutely shuts the door permanently and absolutely on bailouts. I do not think there are many Members of the House who do not want to shut that door.

The idea of hiding which companies are tier one seems absurd. First, we are in favor of transparency. Second, everybody will know anyway. And, third, I think if we are going to require additional capital of certain companies, that will identify who is tier one. If we do not require additional capital of tier one companies, then we are going to give them the possibility of being bailed out and being a systemic risk without even requiring additional capital.

Professor Johnson, you put forward an interesting idea of trying to limit size but pointed out how do we apply this to foreign-based banks? One idea would be to say that no financial institution could have actual or contingent liabilities to Americans in excess of $100 billion or $200 billion or whatever the figure is. So that Deutsche Bank or Bank of America could pose the same level of risk to the United States economy. If the German government wants Deutsche Bank to have liabilities to Germans of a couple of trillion, that is up to them, but if a bailout is necessary, it will be because of the effect its collapse could have on the German economy and presumably that money would come from Berlin. Could you comment on the idea of setting an absolute limit on the size that a financial institution could be in the American economy measured by its actual or contingent liabilities to Americans?

Mr. JOHNSON. Certainly, and obviously this raises complications in terms of international agreements. It is not something you would necessarily do unilaterally, but I think that is why you need the G–20 to be brought with you.

Mr. SHERMAN. The G–20 will never do this. We have a right to say that you cannot borrow more than a certain amount from Americans as a single financial institution.

Mr. JOHNSON. No, I agree completely.

Mr. SHERMAN. And if we were to do it and they were to disagree, what are they going to do to us? Go on.

Mr. JOHNSON. I completely agree with you. I was just talking about process. Look, I think you do this in terms of anybody who is deposit taking. So if you look at what went wrong with Icelandic banks in the UK, for example, at the retail level, they participated in the deposit insurance scheme of the UK and that took care of people with deposits below the UK limit. The issue was the other liabilities to UK citizens. And they obviously got into a very nasty fight with the British government about what assets all of those Icelandic banks would be used to settle up those debts. And I think what you are pointing to is exactly what implicitly came out of this, which is the British government felt that they could claim a lot of these Icelandic assets in the UK, that was supposedly in the UK. They even threatened to use anti-terrorist legislation to do that. That is where this thing is heading unless and until the United States impose these kinds of limits.

Mr. SHERMAN. Would we, if we are going to limit too big to fail means too big to exist, can we do that just for depository institutions and/or their holding companies? Or if we are going to protect the American people from both systemic risk and the risk of having being called upon to make a bailout, do we need to apply it to entities other than banks?

Mr. JOHNSON. I think you have to apply it to entities other than banks. I realize that I am quite far from the consensus view on this, but I think that it is really very important. When we are talking about all financial institutions, I think we have not talked enough about insurance companies today actually. The conversation has tended to gravitate towards commercial banks. I would not assume that the next financial crisis is going to be just like this financial crisis. They tend to mutate. They tend to involve other kinds of risk-taking institutions where we do not fully understand to measure the risk. So I think your point is very important, it has to be broad and it has to be across a lot of financial institutions.

Mr. SHERMAN. Ms. Rivlin, I wonder—you seem to have a comment?

Ms. RIVLIN. No, I agree with that, and I was glad to get a chance to counteract the absent Mr. Wallison who thinks we only need to worry about banks. I think the lesson of this crisis is we need to worry about the whole financial sector and a lot of the trouble came from outside the banking system.

The CHAIRMAN. I am going to recognize myself, and I will give myself one more round, having to come back to this for about 2 minutes, and that is I want to deal with this notion that we are somehow—it seems to me people have gotten attached to a whipping boy and unwilling to be torn away from it, the whipping boy with the name tier one companies. We have said we are not going to name tier one companies, and some people are reluctant to move on. And they say, "Oh, well, you will have secret tier one companies." No, there will not be any tier ones in the legislation we are dealing with. And you say, "Well, but if you are raising capital," well, the requirement that people raise capital will not only apply to the largest. There will be a general thing. So, again, I think people have decided this is a nice thing to attack. I want to make it very clear, there is no tier one.

There was a great Marx Brothers movie in which Chico is negotiating a contract with Groucho and Chico keeps objecting to this cause and that cause, and they keep tearing up the causes. And, finally, Chico says, "What's this?" And Groucho says, "Well, you cannot object to that. That is the sanity clause." And Chico rips that up and says, "Hey, you cannot kid me. There ain't no sanity clause." Well, there ain't no tier one either. It is just not there, so people have to let that whipping boy and strawman go.

Mr. SHERMAN. If the chairman will yield? Whether tier one are identified or not identified, as long as companies are eligible for bailouts, the ones most eligible will be the biggest.

The CHAIRMAN. No question about it, but that is your argument, what you are saying is anything big. So I understand the gentleman's position is a law, which of course would not be persuasive, by the way, you are arguing against yourself, because all you could pass would be a statute that said there could never be a bailout. And what can you do to a statute?

Mr. SHERMAN. You could repeal it.

The CHAIRMAN. I will yield again to the gentleman. In fact, the TARP was a statute. So if there had been a law on the books that said you can never have a bailout, it would have been amended by the TARP. There was no way under the Constitution. So if you posit that at some point people are going to say, "Oh, I have to have a bailout. You cannot stop me, I am jonesin' to do a bailout," then there is no way around that. I do believe there are structural things you can do but let's not have the strawman of the tier one or the company. If you say, "As long as they are a big company, then people will think there could be a bailout," even if there is a statute that says no bailout, it is not binding against the present statute.

I yield to the gentleman.

Mr. SHERMAN. I would think that there is a huge difference between adopting the President's proposal, which is permanent power for bailouts, and saying, "Yes, there could be a bailout if you can pass it on the Floor at some other time."

The CHAIRMAN. I will take my time back to say that I do not know where the gentleman thinks he is. We are not confined to picking Plan A or Plan B. We are going to write the bill, and it is not necessarily what the President does. We are going to deviate from what the President does in a number of cases, as witness to the fact that they have these tier one companies. And I understand it is a lot easier to beat up the tier one companies, but that fight is over. There are not going to be any inside, outside. And the fact that capital requirements are increased will not be a tip off because all manner of institutions will be told, small banks will be told by the FDIC, others will be told, to increase capital.

So if you are convinced, I think probably the only way you could break the habit is there would be a couple of people who fail. So I would differ with the gentleman in this sense, I think the likelihood of this society holding to an absolute 100 percent hard and fast never a bailout is less likely than a resolving regime that would say you have to fire the CEO, that you have to fire the board of directors, that you have to impose other penalties. You have to make it really unpleasant. And that rule out in the course of that,

as sometimes happens in a bankruptcy, some payment. Those are the two choices but it is not the strawman that people wanted.

The gentleman from Colorado?

Mr. PERLMUTTER. Thank you, Mr. Chairman. And I think I agree with the chairman on increasing capitalization for all institutions, and especially in good times increase the capital, in bad times, give them a little bit of a break. But I guess sort of as a philosophical economic question to the panel, whether we are better off or worse off having over the years slowly eroded and chipped away at Glass-Steagall and unit banking so that we have separated the investment side, the stock traders from the bankers and the insurance company, and we have made banks stand—every bank stand on its own capital? So that would be my first question to the panel. Are we better off by having a more efficient system or were we better off by having every bank stood on its own merits, and we kept the investment side separate from the banking side?

Ms. RIVLIN. In other words, should we never have passed Gramm-Leach-Bliley?

Mr. PERLMUTTER. And Garn-St. Germain and start of national banking and branch banking. We cannot "unring" this bell but just as a general principle, do we want a really efficient system, which is where we headed, and then it all collapsed very quickly, or do we want to put some brakes in the system that do not exist right now?

Ms. RIVLIN. I think we want as efficient a system as we can get consistent with reasonable stability. And I realize that is kind of gobbledygook, but it is a trade off. And if we were to go back to no-branch banking and so forth, I do not think that is either feasible or sensible. But we may have gone too far in allowing growth, and maybe not even for efficiency reasons. And so we need to revisit this question and see where we want the trade off to be.

Mr. PERLMUTTER. Mr. Johnson?

Mr. JOHNSON. Do we really have an efficient system at this point? Mr. Bernanke gave a speech recently where he talked about financial innovation and the value of it, he did not name a single innovation since the 1970's in the financial system, okay. We did not get that much efficiency, I think we need to apply the brakes. I do not think you can go back to where we were before. You cannot "unring" the bell as you said, but I think applying the brakes is absolutely critical.

Mr. PERLMUTTER. And how would you do that?

Mr. JOHNSON. The main thing, the main proposal I put forward, as we have been discussing, is to reduce the size of the largest financial institutions so that when you find yourself in a collapse or bailout situation, you can say, "No, that is okay, you go to bankruptcy. You sort it out with your creditors." You are more like CIT Group last week than Citibank over the past 6 or 9 months.

Mr. PERLMUTTER. Or could you demand sort of as a compromise to that that you do not break up the bank or reduce their size and make them spin something off but you say, as to the Northeast, you have to show capital for Massachusetts, Connecticut, Maine, New York, whatever, so that you have a version of unit banking, that your bank has to stand on capital based on a section of the country? There are a lot of ways to deal with this. The chairman

and I have been in a disagreement. I think that really you have to look at both the size of the institutions as well as their product mix, not just markets—not just capitalization, but I am trying to find something that maybe I can get him to bite on.

The CHAIRMAN. If the gentleman will yield?

Mr. PERLMUTTER. Yes, I certainly would yield to the chairman.

The CHAIRMAN. My disagreement is I cannot get the gentleman to tell me what he proposes?

Mr. PERLMUTTER. Well, I am asking the experts.

The CHAIRMAN. Well, the gentleman referred to a disagreement. The only disagreement is I cannot understand what you are talking about. I have asked you to tell me what it is you want to do.

Mr. PERLMUTTER. I know what I want to do. I want to reduce the size of some of the biggest institutions.

The CHAIRMAN. With regard to Glass-Steagall, are you proposing we repeal Gramm-Leach-Bliley? I keep asking the gentleman because he made it public, what would the gentleman do to restore it?

Mr. PERLMUTTER. Mr. Johnson, please help me here?

Mr. JOHNSON. If I could make a suggestion, I would not go on the—perhaps the chairman would consider a graduated capital requirement so that it is not the zero one, tier one or not, but a capital requirement that increases quite sharply, because we know the system risk, an amount of extra GDP that is taken on when these big guys fail is enormous, so this is a very sharply increasing curve.

The CHAIRMAN. When I said a disproportionate increase in capital, that is what I meant.

Mr. JOHNSON. The question is in the numbers then. I think the question is, how fast does it increase? How big is the disincentive to size?

Mr. ZANDI. I do not think you want to go back to any kind of regional kind of criteria. If you remember back historically, we had vicious regional economic cycles in large part because of unit banking, because the bank was stuck to its region and exacerbated the downturn in those regions. And so we had very severe regional economic cycles in large part because of the unit banking system that we had, so I think that would be very counterproductive, very counterproductive.

Mr. MAHONEY. I completely agree with that point. I would also just note that in the crisis, what you saw is that institutions that had a lot of exposure to subprime did very badly. Some of those were stand-alone investment banks like Lehman. Some of them were more or less stand-alone commercial banks like Countrywide. Some were combined investment and commercial banks like Citigroup. So I do not think that that is a strong piece of evidence that we need to reestablish Glass-Steagall.

Mr. PERLMUTTER. Thank you, and I yield back.

The CHAIRMAN. I am going to just take time, since the gentleman raised it, I frankly did not recognize my views as he characterized them. I still do not understand what the proposal—yes, in terms of capital requirements, I very much agree but the gentleman has not given me any idea with which I could disagree.

Mr. PERLMUTTER. The gentleman is working on it, and that is why he was asking the panel for some assistance. And if I cannot come up with an answer that satisfies you, then I cannot come up with an answer.

The CHAIRMAN. But characterizing it as disagreement is sort of puzzling.

Mr. SHERMAN. If the gentleman will yield? I did put forward an idea, not based on whether you are mixing investment banking with insurance and the Glass-Steagall idea, but just a dollar limit. You cannot have debts to Americans in excess of $100 billion.

The CHAIRMAN. Well, I agree, but that is not the specific point. The gentleman from Colorado was specifically referencing Glass-Steagall. Part of this hearing is to get out on the table vague ideas. Is it too big to fail? One of the arguments—

Mr. PERLMUTTER. Would the gentleman yield?

The CHAIRMAN. —would be bring back Glass-Steagall? If that is what people want, discuss it. Your proposal—

Mr. PERLMUTTER. Mine is certainly like a Glass-Steagall. I do not believe that, and I think that the investment banking community is all about risk, and I think they should be allowed to do whatever derivatives they want to do, subject to disclosing to their investors in an open fashion. And they are over in this part of the investment or in the financial community. And the banking system, which I believe is like a public utility, which is why we pumped in $700 billion because we had to keep the lights on, and we intervened in substantial ways through the Fed, that is in my opinion what we had to do last fall, which was a radicalizing moment for me. So I just believe that they really look at the world differently.

The CHAIRMAN. I understand that but does the gentleman—first of all, that does not account for AIG. AIG was not a bank. AIG was doing derivatives and the Federal Reserve intervened without us. People should remember that the Federal Reserve with the approval of Treasury came to us and announced that they were intervening. It was not part of the TARP initially, they just did that on their own. Mr. Wallison said it was not necessary but it was not because they were banks.

But my other point to the gentleman is you say that, what is it—we have been talking about this for months, and I still do not know what is it you are proposing?

Mr. PERLMUTTER. I am proposing, one, to limit the amount of deposits a single institution can take, which right now is 10 percent.

The CHAIRMAN. That is not what we are talking about.

Mr. PERLMUTTER. I am talking about size and product mix. So I am also saying that insurance companies cannot be part—insurance companies, stock trading companies and banks should be separate, as they were Glass-Steagall. I believe that the Roosevelt Administration did the right thing when its first act was Glass-Steagall to separate those—

The CHAIRMAN. Are you proposing that we be imposing Glass-Steagall? That is the first I have heard of your proposing that as a solution.

Mr. PERLMUTTER. That is the best way I can articulate what it is that I believe. So with that, I yield back.

The CHAIRMAN. The gentleman from Indiana?

Mr. DONNELLY. Thank you, Mr. Chairman. We have been talking about too big to fail, and there is another area and that is too big of an effect on the entire market. And, Mr. Zandi, I want to ask you, and I read your statement where it talked about emerging market investors did little or no research of their own and that the credit—this could not have occurred without someone providing the credit. But did not the triple A ratings given by Moody, is not that how the credit flowed was if you give me triple A, the credit will come from that? And so we had a large investor who talked to us and said if the credit rating agencies had not done that, this never would have started in the first place?

Mr. ZANDI. Well, let me just reiterate, I am an employee of the Moody's organization but these are my own personal views.

Mr. DONNELLY. No, I understand.

Mr. ZANDI. And I think there is plenty of blame to go around in that chain of securitization, from the lender to the investment bank, to the rating agency, to the investor, all of them were culpable, all of them made mistakes, all of them were wrong. And if you read through the entire statement, I go through that chain.

Mr. DONNELLY. Right, and I did. And I guess what I am asking is we have been talking about solutions to this.

Mr. ZANDI. Yes.

Mr. DONNELLY. And so with the credit rating agencies, the question is what keeps a Moody's from being in the same position with their triple A ratings again?

Mr. ZANDI. Right.

Mr. DONNELLY. And that is what we have been looking at. And we have talked about cutting the cord or the apparent conflict of interest of the person who is asking you to rate these securities being the same one who pays the fees. And there have been a couple of things offered, and I guess I wanted to get your opinion, is it something that, like they do in the legal world when you go to file a case, that the judge is pulled out of a hat so you cannot pick your judge. And so is this in effect a number of these organizations are put in a hat and that you cannot say, "I want Moody's because they will give me a triple A?"

Mr. ZANDI. Right. And I think that in my own personal view is worth an experiment. I do not know if that works better or not, but I think it probably is an idea that is worth some experimentation.

There are a number of things though that I think should be done. I think the reliance on ratings in regulatory requirements is inappropriate. Right now, if you are a money market fund, it can say I can only invest in securities with a rating of above a certain amount, I think that is inappropriate. Regulators are outsourcing their function to the rating agencies, and they should not do that.

I think the SEC, as the regulator of the rating agencies, should be more active in monitoring and evaluating what the rating agencies are doing, much like banking regulators do with credit risk officers of major commercial banks. They look at the model. They say does this make sense and should it be doing this?

I think it should be required that the data that the rating agencies use in the ratings should be vetted in some way. One of the biggest problems, in my view, was that the rating agencies would say, "You give me the data, I do not re-underwrite the loan, I take

it as given and then I rate." And they say that to everybody, the investment bank and the investor, "That is not what we do, and that is the way it has been since we started our business 100 years ago," but that makes no sense to me. There should be a third party firm that vets the data, samples the data, and makes sure it is okay.

So, I think all these things could be—should be implemented and tried. But let me say one thing, and this is no win for me, right, because you are not going to believe me anyway?

Mr. DONNELLY. No, no, that is not true. I read your book and everything.

Mr. ZANDI. Okay. But bottom line, I do not believe that this conflict of interest, and there is one, is fundamentally why they screwed up, why they made a mistake in the ratings. I do not believe that is it. I think it is these other issues that we have discussed. And I do not think, I would experiment with the approach you just articulated, but fundamentally you are going to have conflicts no matter what you do and no matter how you design it and it is a matter of managing the conflicts as best you can.

Mr. DONNELLY. One of the other things the investor, this fellow, talked about was, and he talked to all of us, was maybe what we ought to do is just throw a couple of cents on every tray and have in effect a quasi-public rating system so that we do not have to speculate on the opinion of Moody's or that they be part of in effect almost become like a public utility, that it is too important getting this right to our economy, to the global economy. We had the Fed chairman in today who said if we had let this get out of hand, the whole global economy would have collapsed. And so much of it was tied in to these incorrect ratings given by Moody's and others.

Mr. ZANDI. Well, let me just say two things. One, I think a fee, a transaction fee, is a good way to raise revenue, the only problem is you have to do it globally.

Mr. DONNELLY. Right.

Mr. ZANDI. You cannot just do it here because it is—

Mr. DONNELLY. Then you are not non-competitive.

Mr. ZANDI. —just not going to work.

Mr. DONNELLY. Right.

Mr. ZANDI. And talk about G–20—

Mr. DONNELLY. But what we are trying to do is we are throwing out ideas of how we can fix this.

Mr. ZANDI. Yes.

Mr. DONNELLY. Anything from any of you.

Mr. ZANDI. In a financial transaction, it might be a good way to raise revenue to self-finance too-big-to-fail, right? It is a way to generate revenue, you put in the fund so that might be a way to do it, but you cannot do it unless it is a global process.

The CHAIRMAN. Mr. Johnson wanted to say something, I think.

Mr. JOHNSON. I think there is an assumption here, which is that we will get it right next time. The analytics will be better, the politics will be better.

Mr. DONNELLY. And that is why I said, why can we assume that next time we will do it any better?

Mr. JOHNSON. I am not opposed to these ideas, let's try them, but fundamentally we will get it wrong again. We have every reason

to think we just have not changed the nature of human society and human judgment and the politics of the entire process and the power of the most powerful people in the system, so a quasi-public rating system will get it wrong also. And you should plan, we should design something that can withstand the failure of that. It may be a good idea to tweak it, I am not opposed to that. But I think we should design something that—and the only way I think to do that is to make sure that when things fail, they are not so big relative to the economy.

The CHAIRMAN. Let me at this point because I want to close it out, but one point Mr. Zandi makes, we are making progress in reaching consensus, such as with the tier one companies. I think that it is overwhelmingly likely that we will repeal all statutory mandates to rely on rating agencies, and that we will instruct the regulatory agencies to examine theirs. So that is one way to deal with. That one I can guarantee you will be in the final bill, that all those—there are two forms. In some cases, people are not allowed to do certain things unless they get a certain rating. In other cases, people cannot invest in other entities unless they have certain rating. We are combing the statutes now. There is agreement, that is something that was independently come up with in the Republican plan and our plan. That will happen.

Mr. SHERMAN. Mr. Chairman?

The CHAIRMAN. Sure.

Mr. SHERMAN. I thought we were going to do another round. I wonder if I could have 1 minute then?

The CHAIRMAN. Sure.

Mr. SHERMAN. I would just say that we are trying to minimize the belief on Wall Street that particular companies have somehow a Federal guarantee. The best way to do that is to have no bailout authority vested in Treasury unless and until some future statute is passed. TARP will expire, and then Wall Street would have to recognize that it would be very difficult under any circumstances to pass TARP again. The way to maximize the belief on Wall Street that those companies that they identify as systemically important are going to get a Federal bailout, and therefore are entitled to lower-cost capital is to vest in Treasury the right to bail out companies. And the fact that the management of that company might lose its job is of little interest to the counterparties. What we are trying to do is make sure that the cost of capital does not reflect the belief that there may be a bailout of the institution. And whether management comes or goes, it does not really matter to the rating institution.

The CHAIRMAN. Will the gentleman yield?

Mr. SHERMAN. I yield.

The CHAIRMAN. Would the gentleman identify to me, because we obviously have not done it yet, but what in the—is it in the resolving authority, where do you find this bail-out authority?

Mr. SHERMAN. The bail-out authority, I think, was well-summarized by Mr. Mahoney.

The CHAIRMAN. No, but I am asking you where you found it in the Administration's position because I think you have overstated it significantly? Where in the Administration's position are they asking for money to be able to give out?

Mr. SHERMAN. I do not have—they do not ask for an appropriation. I do not have a copy of the proposal. I do have Mr. Mahoney's testimony, and my statements are fully consistent with the second page of his testimony.

The CHAIRMAN. Mr. Mahoney, do you have the reference? What is it that you think constitutes bail-out authority?

Mr. MAHONEY. Well, I think it is the—there is a statement that in the special resolution procedure, there are all these authorities given to spend money. Now, the White Paper does not say where the money comes from. I believe there was—

The CHAIRMAN. The question would not be where it came from, but where it went to. Is the authorization to bail out creditors?

Mr. MAHONEY. The authorization is to re-capitalize, to purchase assets from, to make loans to, and that would go directly from Treasury into the—

The CHAIRMAN. My understanding of it was regarding the bankruptcy situation, where you were not paying off old debts but trying to get things going forward, but we will look at that.

Mr. MAHONEY. If that is all that is being talked about, then that is great, but I certainly did not read it that way.

The CHAIRMAN. It is in the White Paper?

Mr. MAHONEY. That is right.

The CHAIRMAN. That is not our impression but, again, that will be our decision. The hearing is adjourned.

I apologize, the Property and Casualty Insurance Association asked that we submit a statement. Any member who wishes to submit any information, including any of the witnesses, without objection, the hearing record will be open for 30 days.

[Whereupon, at 5 p.m., the hearing was adjourned.]

A P P E N D I X

July 21, 2009

Statement by Representative Carolyn McCarthy
Financial Services Committee
"Systemic Risk: Are Some Institutions Too Big To Fail and If So, What Should We Do about It?"
July 21, 2009

I applaud Chairman Frank for holding this very important hearing to define when a company is too largely structured for the government to allow them to fail. As we move forward, this determination is a key issue that the Committee will consider as we look to address current and future risks and avoid future economic meltdowns.

Whether a company is deemed "too big to fail,"or "too interconnected" it is clear that something must to be done to make sure the entire US economy will not come crashing down as a result of their potential failure. I look forward to working with my colleagues on the Committee to create a regulatory function that will determine and monitor activity that promote systemic risk. Additionally, a company should not have the ability to become so intertwined that any slight shift truly disrupts the markets and ultimately the economy. Competition and innovation should be encouraged, but not to a point that potential failure causes an economic crisis.

Testimony submitted to the House Committee on Financial Services, Hearing on "Systemic Risk: Are Some Institutions Too Big To Fail And If So, What Should We Do About It?" Tuesday, July 21, 2009, 2pm.

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of http://BaselineScenario.com.[1]

Main Points

1) The U.S. economic system has evolved relatively effective ways of handling the insolvency of nonfinancial firms (through bankruptcy) and small or medium-sized financial institutions with retail deposits (through a FDIC-run intervention process). These kinds of corporate failures inflict limited costs on the real economy, and even a string of problems in such firms does not generally jeopardize the entire financial system.

2) We do not yet have a similarly effective way to deal with the insolvency of large financial institutions (e.g., any bank with assets over $500bn, which is roughly 3 percent of GDP). When one of these firms gets into trouble, the authorities face an unpalatable choice of "bailout or collapse." If the problems spread to more than one firm, the balance of responsible official thinking shifts towards: "bailout, at any cost".

3) The collapse of a single large bank, insurance company, or other financial intermediary can have serious negative consequences for the U.S. economy. Even worse, it can trigger further bank failures both within the United States and in other countries – and failures elsewhere in the world can quickly create further problems that impact our financial system and those of our major trading partners.

4) As a result, we currently face a high degree of systemic risk, both within the United States and across the global financial system. This risk is high in historical terms for the US, higher than experienced in most countries previously, and probably unprecedented in its global dimensions.

5) Short-term measures taken by the US government since fall 2008 (and particularly under the Obama administration) have helped stabilized financial markets – primarily by providing unprecedented levels of direct and indirect support to large banks. But these same measures have not removed the longer-run causes of systemic instability. In fact, as a result of supporting leading institutions on terms that are generous to top bank executives (few have been fired or faced other adverse consequences), systemic risk has likely been exacerbated.

6) Some of our largest financial firms have actually become bigger relative to the system and stronger politically as a result of the crisis. Executives of the surviving large firms have every reason to believe they are "too big to fail." They have no incentive to help bring system risk down to acceptable levels.

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[1] This testimony draws on previous and ongoing work with James Kwak, particularly The Quiet Coup (*The Atlantic*, May 2009), and Peter Boone. Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com, where we also provide daily updates and detailed policy assessments.

7) Specifically, the surviving large U.S. financial firms and their foreign competitors have a strong incentive to resume "pay-for-performance" incentive systems – they compete by attracting "talent," and if any one firm brings its compensation under control, it will lose skilled employees. But these firms – and their regulators – have also demonstrated they cannot prevent such incentives from becoming "pay-for-disguised-risk-taking" on a massive scale.

8) The potential for unacceptable systemic risk remains deeply engrained in the culture and organizational structure of Big Finance. Over the past 30 years, this sector has benefited from a process of "cultural capture," through which regulators, politicians, and independent analysts became convinced this sector had great and stabilizing technical expertise. This belief system is increasingly disputed, but still remains substantially in place – big banks are, amazingly, still presumed by officials to have the expertise necessary to manage their own risks, to prevent system failure, and to guide public policy.

9) There are four potential ways to reduce system risk going forward

    a. Change our regulations so as to reduce ex ante risk-taking, e.g., by more effectively controlling the extent of leverage in the financial system or by more tightly regulating derivatives transactions.

    b. Change the allocation of regulatory authority within the financial system, so that the relative powers of the Federal Reserve, Treasury, FDIC and various other regulators are adjusted.

    c. Make it easier for the authorities to close down failing large financial companies using a revised "resolution authority."

    d. Change the size structure of the financial system, so that there are no financial institutions that are "too big to fail".

10) All of these approaches have some appeal and it makes sense to proceed on a broad front – because it is hard to know what will gain more traction in practice.

11) The growing complexity of global financial markets means that even sophisticated financial sector executives do not necessarily understand the full nature of the risks they are taking on.

12) There is no ideal – or even proven – regulatory structure that will work inside the U.S. political system. Relative to the alternatives, strengthening the FDIC makes sense. For certain levels of potential bailout (e.g., as with CIT Group recently), the FDIC has an effective veto power over providing some forms of government support. This has proved a helpful check on the discretion of the Federal Reserve and the Treasury recently, but it would be a mistake to assume this will be the case indefinitely.

13) While an extended "resolution authority" could be helpful, it is not a panacea. As markets evolve, new forms of interconnections evolve – and we have learned that not even managers of the best run banks understand how that affects the transmission of shocks. Furthermore, as banks become more global, an effective resolution authority would need to span all major countries in comprehensive detail. We are many years away from such an arrangement.

14) The stakes are very high – the country's fiscal position has been significantly worsened by the current crisis, and our debt/GDP ratio is on track to roughly double.

15) As a result, it makes sense also to consider measures that will reduce the size of the largest financial institutions. The recent experience of CIT Group suggests that a total asset size under $100bn may provide a rough threshold, at least on an interim basis, below which the government can allow bankruptcy and/or renegotiation with private creditors to proceed.

16) Market-based pressure for size reduction can come through a variety of measures, including higher payments to the FDIC (or equivalent government insurance agency) from institutions that pose greater system risk, higher capital requirements for bigger firms, and differential caps on compensation based on the cost of implied government assistance in the event of a failure – think of this as pre-payment for failure.

17) Breaking up our largest banks is entirely plausible in economic terms. This action would affect less than a dozen entities, could be spread out over a number of years, and would likely increase (rather than reduce) the availability of low-cost financial intermediation services.

18) The political battle to set in place such anti-size measures would be epic. But as in previous financial reform episodes in the United States (e.g., under Teddy Roosevelt at the start of the 20th century or under FDR during the 1930s), over a 3-5 year period even the most powerful financial interests can be brought under control.

19) If we are able to make our largest financial firms smaller, there will still be potential concerns about connected failures or domino effects. Much tougher implementation of "safety and soundness" regulation is the only way to deal with this. In that context, stronger consumer protection – through a new agency focused on the safety of financial products – would definitely help (as well as being a good thing for its own sake).

The remainder of this testimony provides further background regarding how systemic risk developed to its current high levels in the U.S., and suggests why we need new limits on financial institutions whose management regards them as "too big to fail".

Background

The depth and suddenness of the U.S. economic and financial crisis today are strikingly and shockingly reminiscent of experiences we have seen recently only in emerging markets: Korea in 1997, Malaysia in 1998 and even Russia and Argentina, repeatedly.

The common factor in those emerging market crises was a moment when global investors suddenly became afraid that the country in question wouldn't be able to pay off its debts, and stopped lending money overnight. In each case, the fear became self-fulfilling, as banks unable to roll over their debt did, in fact, become unable to pay off all their creditors.

This is precisely what drove Lehman Brothers into bankruptcy on September 15, 2008, and the result was that, overnight, all sources of funding to the U.S. financial sector dried up. From that point, the functioning of the banking sector has depended on the Federal Reserve to provide or guarantee the necessary funding. And, just like in emerging markets crises, the weakness in the banking system has quickly rippled out into the real economy, causing a severe economic contraction and hardship for millions of people.

This part of my testimony examines how the United States became more like an emerging market, the politics of a financial sector with banks that are now "too big to fail," and what this implies for policies that attempt to reduce systemic risk.

How could this happen?

The US has always been subject to booms and busts. The dotcom craze of the late 1990s is a perfect example of our usual cycle; many investors got overexcited and fortunes were lost. But at the end of the day we have the Internet which, like it or not, profoundly changes the way we organize society and make money. The same thing happened in the 19th century with waves of investment in canals, railroad, oil, and any number of manufacturing industries.

This time around, something was different. Behind the usual ups and downs during the past 25 or so years, there was a long boom in financial services – something you can trace back to the deregulation of the Reagan years, but which got a big jolt from increasing global capital flows during the 1990s, the Clinton Administration's refusal to regulate derivatives market effectively, and the complete failure of "safety and soundness" bank regulation under Alan Greenspan and the George W. Bush Administration. Finance became big relative to the economy, largely because of these political decisions, and the great wealth that this sector created and concentrated in turn gave bankers enormous political weight.

This political weight had not been seen in the US since the original J. P. Morgan in the late 1800s/first decade of the 20th century. In that period, the banking panic of 1907 could only be stopped by coordination among private sector bankers, because there was no government entity able to offer an effective counterweight. The first age of banking oligarchs – with great political influence based on economic might – came to an end with the passage of significant banking regulation during and in response to the Great Depression. But the emergence of a financial oligarchy during a long boom is typical of emerging markets.

There were, of course, some facilitating factors behind the crisis. Top investment bankers and government officials like to lay the blame on low U.S. interest rates after the dotcom bust, or even better – for them – the flow of savings out of China. Some on the right of the spectrum like to complain about Fannie Mae or Freddie Mac, or even about longer-standing efforts to promote broader home ownership. And, of course, it is axiomatic to everyone that the regulators responsible for "safety and soundness" were fast asleep at the wheel.

But these various policies - lightweight regulation, cheap money, the unwritten Chinese-American economic alliance, the promotion of homeownership - had something in common, even though some are traditionally associated with Democrats and some with Republicans: they all benefited the financial sector. The underlying problem was that policy changes that might have limited the ability of the financial sector to make money - such as Brooksley Born's attempts at the Commodity Futures Trading Commission to regulate over-the-counter derivatives such as credit default swaps - were ignored or swept aside.

Big banks enjoyed a level of prestige that allowed them to do what they liked, for example with regard to "risk management" systems that allowed them to book large profits (and pay large

bonuses) while taking risks that would be borne in the future – and by the rest of society. Regulators, legislators, and academics almost all assumed the managers of these banks knew what they were doing. In retrospect, of course, they didn't.

Stanley O'Neal, CEO of Merrill Lynch, pushed his firm heavily into the mortgage-backed securities market at its peak in 2005 and 2006; in October 2007, he was forced to say, "The bottom line is we…I…got it wrong by being overexposed to subprime, and we suffered as a result of impaired liquidity…in that market. No one is more disappointed than I am in that result." (O'Neal earned a $14 million bonus in 2006; forced out in October 2007, he walked away with a severance package worth over $160 million, although it is presumably worth much less today.)

At the same time, AIG Financial Products earned over $2 billion in pretax profits in 2005, largely by selling underpriced insurance on complex, poorly-understood securities. Often described as "picking up nickels in front of a steamroller," this strategy is highly profitable in ordinary years, and disastrous in bad years. As of last fall, AIG had outstanding insurance on over $500 billion of securities. To date, the U.S. government has committed close to $200 billion in investments and loans in an effort to rescue AIG from losses largely caused by this one division - and which its sophisticated risk models said would not occur.

"Securitization" of subprime mortgages and other high risk loans created the illusion of diversification. While we should never underestimate the human capacity for self-delusion, what happened to all our oversight mechanisms? From top to bottom, executive, legislative and judicial, were effectively captured, not in the sense of being coerced or corrupted, but in the equally insidious sense of being utterly convinced by whatever the banks told them. Alan Greenspan's pronouncements in favor of unregulated financial markets have been echoed numerous times. But this is what the man who succeeded him said in 2006: "The management of market risk and credit risk has become increasingly sophisticated . . . banking organizations of all sizes have made substantial strides over the past two decades in their ability to measure and manage risks."

And they were captured (or completely persuaded) by exactly the sort of elite that dominates an emerging market. When a country like Indonesia or Korea or Russia grows, some people become rich and more powerful. They engage in some activities that are sensible for the broader economy, but they also load up on risk. They are masters of their mini-universe and they reckon that there is a good chance their political connections will allow them to "put" back to the government any substantial problems that arise. In Thailand, Malaysia, and Indonesia prior to 1997, the business elite was closely interwoven with the government; and for many of the oligarchs, the calculation proved correct – in their time of need, public assistance was forthcoming.

This is a standard way to think about middle income or low income countries. And there are plenty of Americans who are also comfortable with this as a way of describing how some West European countries operate. Unfortunately, this is also essentially how the U.S. operates today.

The U.S. System

Of course, the U.S. is unique. And just as we have the most advanced economy, military, and technology in the world, we also have the most advanced oligarchy.

In a primitive political system, power is transmitted through violence, or the threat of violence: military coups, private militias, etc. In a less primitive system more typical of emerging markets, power is transmitted via money: bribes, kickbacks, and offshore bank accounts. Although lobbying and campaign contributions certainly play a major role in the American political system, old-fashioned corruption - envelopes stuffed with $100 bills – is probably a sideshow today, Jack Abramoff notwithstanding.

Instead, the American financial industry gained political power by amassing a kind of cultural capital – a belief system. Once, perhaps, what was good for General Motors was good for the United States. In the last decade, the attitude took hold in the U.S. that what was good for Big Finance on Wall Street was good for the United States. The banking and securities industry has become one of the top contributors to political campaigns, but at the peak of its influence it did not have to buy favors the way, for example, the tobacco companies or military contractors might have to. Instead, it benefited from the fact that Washington insiders already believed that large financial institutions and free-flowing capital markets were critical to America's position in the world.

One channel of influence was, of course, the flow of individuals between Wall Street and Washington. Robert Rubin, co-chairman of Goldman Sachs, served in Washington as Treasury Secretary under President Clinton, and later became chairman of the executive committee of Citigroup. Henry Paulson, CEO of Goldman Sachs during the long boom, became Treasury Secretary under President George W. Bush. John Snow, an earlier Bush Treasury Secretary, left to become chairman of Cerberus Capital Management, a large private equity firm that also counts Vice President Dan Quayle among its executives. President George H. W. Bush has been an advisor to the Carlyle Group, another major private equity firm. Alan Greenspan, after the Federal Reserve, became a consultant to PIMCO, perhaps the biggest player on international bond markets.

These personal connections - which were multiplied many times over on lower levels of the last three presidential administrations - obviously contributed to the alignment of interests between Wall Street and Washington.

Wall Street itself is a very seductive place, imbued with an aura not only of wealth but of power. The people who man its towers truly believe that they control the levers that make the world go 'round, and a civil servant from Washington invited into their conference rooms, even if just for a meeting, could be forgiven for falling under its sway.

The seduction extended even (or especially) to finance and economics professors, historically confined to the cramped hallways of universities and the pursuit of Nobel Prizes. As mathematical finance became more and more critical to practical finance, professors increasingly took positions as consultants or partners at financial institutions. The most famous example is

probably Myron Scholes and Robert Merton, Nobel Laureates both, taking positions at Long-Term Capital Management, but there are many others. One effect of this migration was to lend the stamp of academic legitimacy (and intellectual intimidation) to the burgeoning world of high finance.

Why did this happen and why now? America is a country that has always been fascinated with rather than repelled by wealth, where people aspire to become rich, or at least associate themselves with the rich, rather than redistribute their wealth downward. And roughly from the 1980s, more and more of the rich have made their money in finance.

There are various reasons for this evolution. Beginning in the 1970s, several factors upset the relatively sleepy world of banking - taking deposits, making commercial and residential loans, executing stock trades, and underwriting debt and equity offerings. The deregulation of stock brokerage commissions in 1975 increased competition and stimulated participation in stock markets.

In *Liar's Poker*, Michael Lewis singles out Paul Volcker's monetary policy and increased volatility in interest rates: this, Lewis argues, made bond trading much more popular and lucrative and, it is true, the markets for bonds and bond-like securities have been where most of the action has been in recent decades. Good old-fashioned innovation certainly played its part: the invention of securitization in the 1970s (and the ability of Salomon Brothers to make outsized amounts of money in mortgage-backed securities in the 1980s), as well as the invention of interest-rate swaps and credit default swaps, vastly increased the volume of transactions that bankers could make money on. Demographics helped: an aging and increasingly wealthy population invested more and more money in securities, helped by the invention of the IRA and the 401(k) plan, again boosting the supply of the raw material from which bankers make money. These developments together vastly increased the opportunities to make money in finance.

Not surprisingly, financial institutions started making a lot more money, beginning in the mid-1980s. 1986 was the first year in the postwar period that the financial sector earned 19% of total domestic corporate profits. In the 1990s, that figure oscillated between 21% and 30%; this decade, it reached as high as 41%. The impact on compensation in the financial sector was even more dramatic. From 1948 to 1982, average compensation in the financial sector varied between 99% and 108% of the average for all domestic private industries. From 1983, it shot upward in nearly a straight line, reaching 181% in 2007.

The results were straightforward. Jobs in finance became more prestigious, people in finance became more prestigious, and the cult of finance seeped into the culture at large, through works like *Liar's Poker*, *Barbarians at the Gate*, *Wall Street*, and *Bonfire of the Vanities*. Even convicted criminals, like Michael Milken and Ivan Boesky, became larger than life. In a country that celebrates the idea of making money, it was easy to infer that the interests of the financial sector were the same as the interests of the country as a whole - and that the winners in the financial sector knew better what was good for American than career civil servants in Washington.

As a consequence, there was no shadowy conspiracy that needed to be pursued in secrecy. Instead, it became a matter of conventional wisdom - trumpeted on the editorial pages of The Wall Street Journal and in the popular press as well as on the floor of Congress - that financial free markets were good for the country as a whole. As the buzz of the dot-com bubble wore off, finance and real estate became the new American obsession. Private equity firms became the destination of choice for business students and hedge funds became the surefire way to make not millions but tens of millions of dollars. In America, where wealth is less resented than celebrated, the masters of the financial universe became objects of admiration or even adulation.

The deregulatory policies of the past decade flowed naturally from this confluence of campaign finance, personal connections, and ideology: insistence on free flows of capital across borders; repeal of the Depression-era regulations separating commercial and investment banking; a Congressional ban on the regulation of credit default swaps; major increases in the amount of leverage allowed to investment banks; a general abdication by the Securities and Exchange Commission of its enforcement responsibilities; an international agreement to allow banks to measure their own riskiness; a short-lived proposal to partially privatize social security; and, most banally but most importantly, a general failure to keep pace with the tremendous pace of innovation in financial markets.

American Oligarchs and the Financial Crisis

The oligarchy and the government policies that aided it did not alone cause the financial crisis that exploded last year. There were many factors that contributed, including excessive borrowing by households and lax lending standards out on the fringes of the financial world. But major commercial and investment banks - and their fellow travelers in and around the financial sector - were the big beneficiaries of the twin housing and asset bubbles of this decade, their profits fed by an ever-increasing volume of transactions founded on a small base of actual physical assets. Each time a loan was sold, packaged, securitized, and resold, banks took their transaction fees, and the hedge funds buying those securities reaped ever-larger management fees as their assets under management grew.

Because everyone was getting richer, and the health of the national economy depended so heavily on growth in real estate and finance, no one in Washington had the incentive to question what was going on. Instead, Fed Chairman Greenspan and President Bush insisted repeatedly that the economy was fundamentally sound and that the tremendous growth in complex securities and credit default swaps were symptoms of a healthy economy where risk was distributed safely.

In summer 2007, the signs of strain started appearing – the boom had produced so much debt that even a small global economic stumble could cause major problems. And from then until the present, the financial sector and the federal government have been behaving exactly the way one would expect after having witnessed emerging market financial crises in the past.

In a financial panic, the critical ingredients of the government response must be speed and overwhelming force. The root problem is uncertainty - in our case, uncertainty about whether the major banks have sufficient assets to cover their liabilities. Half measures combined with wishful

thinking and a wait-and-see attitude is insufficient to overcome this uncertainty. And the longer the response takes, the longer that uncertainty can sap away at the flow of credit, consumer confidence, and the real economy in general - ultimately making the problem much harder to solve.

Instead, however, the principal characteristics of the government's initial response to the financial crisis were denial, lack of transparency, and unwillingness to upset the financial sector.

First, there was the prominent place of policy by deal: when a major financial institution, got into trouble, the Treasury Department and the Federal Reserve would engineer a bailout over the weekend and announce that everything was fine on Monday. In March 2008, there was the sale of Bear Stearns to JPMorgan Chase, which looked to many like a gift to JPMorgan. The deal was brokered by the Federal Reserve Bank of New York - which includes Jamie Dimon, CEO of JPMorgan, on its board of directors. In September, there were the takeover of Fannie Mae and Freddie Mac, the sale of Merrill Lynch to Bank of America, the decision to let Lehman fail, the destructive bailout of AIG, the takeover and immediate sale of Washington Mutual to JPMorgan, and the bidding war between Citigroup and Wells Fargo over the failing Wachovia - all of which were brokered by the government. In October, there was the recapitalization of nine large banks on the same day behind closed doors in Washington. This was followed by additional bailouts for Citigroup, AIG, Bank of America, and Citigroup (again).

In each case, the Treasury Department and the Fed did not act according to any legislated or even announced principles, but simply worked out a deal and claimed that it was the best that could be done under the circumstances. This was late-night, back-room dealing, pure and simple.

What is more telling, though, is the extreme care the government has taken not to upset the interests of the financial institutions themselves, or even to question the basic outlines of the system that got us here.

In September 2008, Henry Paulson asked for $700 billion to buy toxic assets from banks, as well as unconditional authority and freedom from judicial review. Many economists and commentators suspected that the purpose was to overpay for those assets and thereby take the problem off the banks' hands - indeed, that is the only way that buying toxic assets would have helped anything. Perhaps because there was no way to make such a blatant subsidy politically acceptable, that plan was shelved.

Instead, the money was used to recapitalize (buy shares in) banks - on terms that were grossly favorable to the banks. For example, Warren Buffett put new capital into Goldman Sachs just weeks before the Treasury Department invested in nine major banks. Buffett got a higher interest rate on his investment and a much better deal on his options to buy Goldman shares in the future.

As the crisis deepened and financial institutions needed more assistance, the government got more and more creative in figuring out ways to provide subsidies that were too complex for the general public to understand. The first AIG bailout, which was on relatively good terms for the taxpayer, was renegotiated to make it even friendlier to AIG. The second Citigroup and Bank of America bailouts included complex asset guarantees that essentially provided nontransparent

insurance to those banks at well below-market rates. The third Citigroup bailout, in late February 2009, converted preferred stock to common stock at a conversion price that was significantly *higher* than the market price - a subsidy that probably even most *Wall Street Journal* readers would miss on first reading. And the convertible preferred shares that will be provided under the new Financial Stability Plan give the conversion option to the bank in question, not the government - basically giving the bank a valuable option for free.

One problem with this velvet-glove strategy is that it was simply inadequate to change the behavior of a financial sector used to doing business on its own terms. As an unnamed senior bank official said to *The New York Times*, "It doesn't matter how much Hank Paulson gives us, no one is going to lend a nickel until the economy turns."

At the same time, the princes of the financial world assumed that their position as the economy's favored children was safe, despite the wreckage they had caused. John Thain, in the midst of the crisis, asked his board of directors for a $10 million bonus; he withdrew the request amidst a firestorm of protest after it was leaked to the *Wall Street Journal*. Merrill Lynch as a whole was no better, moving its bonus payments forward to December, reportedly (although this is now a matter of some controversy) to avoid the possibility they would be reduced by Bank of America, which would own Merrill beginning on January 1.

This continued solicitousness for the financial sector might be surprising coming from the Obama Administration, which has otherwise not been hesitant to take action. The $800 billion fiscal stimulus plan was watered down by the need to bring three Republican senators on board and ended up smaller than many hoped for, yet still counts as a major achievement under our political system. And in other ways, the new administration has pursued a progressive agenda, for example in signing the Lilly Ledbetter law making it easier for women to sue for discrimination in pay and moving to significantly increase the transparency of government in general (but not vis-à-vis its dealings with the financial sector).

What it shows, however, is that the power of the financial sector goes far beyond a single set of people, a single administration, or a single political party. It is based not on a few personal connections, but on an ideology according to which the interests of Big Finance and the interests of the American people are naturally aligned - an ideology that assumes the private sector is always best, simply because it is the private sector, and hence the government should never tell the private sector what to do, but should only ask nicely, and maybe provide some financial handouts to keep the private sector alive.

To those who live outside the Treasury-Wall Street corridor, this ideology is increasingly not only at odds with reality, but actually dangerous to the economy.

The Way Out

Looking just at the financial crisis (and leaving aside some problems of the larger economy), we face at least two major, interrelated problems. The first is a desperately ill banking sector that threatens to choke off any incipient recovery that the fiscal stimulus might be able to generate.

The second is a network of connections and ideology that give the financial sector a veto over public policy, even as it loses popular support.

That network, it seems, has only gotten stronger since the crisis began. And this is not surprising. With the financial system still fragile, the potential damage that a major bank could cause - Lehman was small relative to Citigroup or Bank of America - is much greater than it would be during ordinary times. The banks have been exploiting this fear to wring favorable deals out of Washington. Bank of America obtained its second bailout package (in January 2009) by first threatening not to go through with the acquisition of Merrill Lynch - a prospect that Treasury did not want to consider (although the details of exactly who forced whom to do what remain rather murky).

In some ways, of course, the government is deeply involved with parts of the banking system – having sunk hundreds of billions of dollars into banks directly and through debt guarantees. And the Federal Reserve has taken on a major role in providing credit to the real economy. We have state supported finance without much control over banks or anything else.

One solution is to scale-up the standard FDIC process. A Federal Deposit Insurance Corporation (FDIC) "intervention" is essentially a government-managed bankruptcy procedure for banks. Organizing systematic tough assessments of capital adequacy, followed by such interventions, would simplify enormously the job of cleaning up the balance sheets of the banking system.

One problem over the past nine months was that Treasury negotiated each bailout with the bank being saved, yet Treasury is still paradoxically - but logically, given their anachronistic belief system - behaving as if the bank holds all the cards, contorting the terms of the deal to minimize government ownership while forswearing any real influence over the bank.

Surely, the most important lesson from this financial crisis is that we never again want to be in the same position: none of the available choices. There is nothing we have "learned" that would make next time any less painful or any less costly, either in terms of the budgetary impact or the decline in the real economy.

But the second challenge - the power of the oligarchy - is just as important as the first. And the advice from those with experience in severe banking crises would be just as simple: break the oligarchy.

In the U.S. today, this means creating a market-based incentive to break up the oversized institutions that have a disproportionate influence on public policy. And it means splitting a single interest group into competing sub-groups with different interests. How do we do this?

Larger banks should become more costly to operate, either due to higher capital requirements, a larger insurance premium paid to the FDIC (or equivalent), or caps on compensation – or all of the above. Over time, as the economy recovers, these constraints can be tightened – pushing the large banks to divest themselves of standalone units.

This may seem like a crude set of incentives, but it is the most direct way to limit the power of individual institutions, especially in a sector that, the last year has taught us, is even more critical to the economy as a whole than anyone had imagined.

Of course, some will complain about "efficiency costs" from breaking up banks, and they may have a point. But you need to weigh any such costs against the benefits of no longer having banks that are too big to fail. Anything that is "too big to fail" is now "too big to exist."

Further regulation of behavior is definitely needed; there will be costs, but think of the benefits to the system as a whole. In the long run, the only good solution may be better competition - finally breaking the non-competitive pricing structures of hedge funds, and bringing down the fees of the asset management and banking industry in general. To those who say this would drive financial activities to other countries, we can now safely say: fine; although we also need to work urgently within the G20 to ensure de-escalation of global financial system risk.

Of course, all of this is at best a temporary solution. The economy will recover some day, and Wall Street will be there to welcome the most financially ambitious graduates of the world's top universities. The best we can do is put in place structural constraints on the financial sector – including antitrust rules and stronger regulations - and hope that they are not repealed amidst the euphoria of a boom too soon in the future. In the meantime, we can invest in education, research, and development with the goal of developing new leading sectors of our economy, based on technological rather than financial innovation.

In a democratic capitalist society, political power flows towards those with economic power. And as society becomes more sophisticated, the forms of that power also become more sophisticated. Until we come up with a form of political organization that is less susceptible to economic influences, oligarchs - like booms and busts - are something that we must account for and be prepared for. The crucial first step is recognizing that we have them.

Testimony of Paul G. Mahoney

Dean, University of Virginia School of Law

Before the

United States House of Representatives

Committee on Financial Services

Tuesday, July 21, 2009

Chairman Frank, Ranking Member Bachus, and members of the committee, my name is Paul Mahoney. I am the dean of the University of Virginia Law School, where my teaching and research interests include contracts, securities regulation, derivatives regulation, and law and development.

I appreciate the opportunity to present my views, simply as an observer of the financial services industry and not on behalf of any industry or organization. I will discuss those portions of the Obama Administration's financial regulatory reform proposals that deal with the largest financial institutions—so-called "Tier 1 Financial Holding Companies". The Treasury Department's white paper *Financial Regulatory Reform: A New Foundation* defines a Tier 1 FHC as "any financial firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability." That definition makes clear that the proposal accepts the view that these large and interconnected institutions are "too big to fail" because of their systemic importance.

The white paper proposes creation of a special resolution regime outside the normal bankruptcy process for financial holding companies that would be triggered when, in the Treasury's view, the "stability of the financial system is at risk." It appears that this standard would typically be met in the case of the failure of a Tier 1 FHC in light of the definition of that term. When Treasury triggers the special resolution regime, it will have the authority to lend the institution money, purchase its assets, guarantee its liabilities, or provide equity capital. I think it is fair to use the term "bailout" to describe that combination of powers and I use it as such.

Federal regulators have not paid sufficient attention to sources of systemic risk, or risks that affect the entire financial sector rather than a single firm. The creation of a council tasked

with identifying and warning functional regulators about sources of systemic risk is a good idea. Taking a close look at the process for resolving insolvent financial holding companies in order to prevent uncertainty and delay is also a good idea. Nevertheless, the identification of particular firms as too big to fail and, therefore, the beneficiaries of an implicit government guarantee, is a bad idea. I also believe oversight and enforcement powers should remain with the functional regulators and the systemic risk council should serve in an advisory role.

Since the beginning of the current financial downturn, the federal government has provided cash infusions, guarantees, and subsidies potentially amounting to trillions of dollars to prevent the collapse of large financial institutions. Given the cost of these bailouts and the potential they create for future moral hazard, Congress is rightly determined to minimize the likelihood of their repetition in the future.

There are two general schools of thought on how best to avoid future bailouts. The first holds that it was an error to help creditors of the failed institutions avoid losses that they would have realized in a normal bankruptcy proceeding and that the focus of policy going forward should be to make it clear that the mistake will not be repeated. While the government cannot easily commit never to do something in the future, Congress could limit the Treasury's and Federal Reserve's authority to commit funds to distressed financial holding companies institutions outside the ordinary bankruptcy or resolution process.

The alternative is to concede that the government will not refuse to bail out large and systemically important financial institutions. Under this approach, Congress should focus on limiting the risks that these institutions may take in order to minimize the likelihood that they will become financially distressed. If these efforts fail and a systemically important institution

becomes financially distressed, a bailout will follow as a matter of course. The administration's financial reform blueprint takes this approach.

I believe the first approach will produce a healthier financial services industry that will make fewer claims on taxpayer dollars. It is based on a sounder premise—that the best way to reduce moral hazard is to ensure that economic agents bear the costs of their own mistakes. The administration's plan is premised on the view that regulatory oversight will compensate for misaligned incentives.

The central argument for trying to avoid bailouts through regulatory oversight rather than insisting that financial institutions bear the cost of their mistakes is that some financial institutions are "too big to fail." Putting such institutions through bankruptcy or a similar resolution process, and thereby requiring their creditors and counterparties to recognize losses or sell collateral, could spread contagion, meaning that other banks or financial institutions may also fail as a consequence. Widespread bank failures, in turn, may reduce the availability of credit to the real economy, causing or exacerbating a recession.

These arguments are plausible but it is not clear that the magnitude of the problem is sufficient to justify the scale of government intervention that we have seen in the past year. It is important to note that the loss of bank capital in the recent crisis was not just the result of a temporary liquidity problem—it was the consequence of sharp declines in real estate and other asset values. A bailout can redistribute those losses to taxpayers, but it cannot avoid them. The TARP fund was conceived initially as a system for purchasing illiquid bank assets and then selling them back once the perceived liquidity crisis was past. Once it became clear that the problem was solvency, not liquidity, the program was changed and the funds used to recapitalize financial institutions.

The bankruptcy process is an alternative means of recapitalizing an insolvent institution. Bankruptcy does not imply or require that the firm's assets, employees, and know-how disappear. Instead, it rearranges the external claims on the firm's assets and cash flows. The holders of the firm's equity may be wiped out entirely, while unsecured creditors may have to substitute part or all of their debt claims for equity claims, thereby re-establishing a sound capital structure. If the insolvent financial institution still has the skill and experience to facilitate credit formation, it will continue to do so under new ownership, management, and financial structure. Of course, the bankruptcy process is subject to inefficiencies and delays and these should be addressed when possible. But they do not require an alternative regime of bailouts.

A bailout regime creates substantial moral hazard problems that impose costs on the banking sector continuously, not just during crises.[1] Because creditors of too big to fail financial institutions anticipate that they will be able to shift some or all of their losses to taxpayers, they do not charge enough for the capital they provide. The financial institution, in turn, does not pay a sufficient price for taking risk. The result is a dangerous feedback loop: large banks have access to cheap capital, which causes them to grow even larger and more systemically important while taking excessive risks, all of which increase the probability of a crisis. Thus a bailout regime leads to more frequent crises even as it attempts to insulate creditors from them.

The Administration believes that its proposal will alleviate moral hazard and decrease the concentration of risk in "too big to fail" institutions. The idea is that so-called "Tier 1" financial holding companies will be subject to more stringent capital rules that will simultaneously reduce the amount of risk they can take and create a disincentive to become a Tier 1 FHC in the first place.

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[1] This point is made in detail in Gary H. Stern & Ron J. Feldman, *Too Big to Fail: The Hazards of Bank Bailouts* (Washington, DC, Brookings Institution 2004).

I believe that these disincentives are insufficient and implementation of the plan would increase, not decrease, the concentration of risk. Once a firm has been designated a Tier 1 FHC, other financial institutions will view it as having an implicit government guarantee, as they did Fannie Mae and Freddie Mac. The theory behind the Administration's proposal is that this advantage will be offset by stricter capital requirements and other regulatory costs that will, on balance, make the cost of capital higher, not lower, for Tier 1 FHCs.

Such a system would put greater demands on the Federal Reserve than any regulator could reasonably meet. Having an implicit government guarantee, Tier 1 FHCs will be extremely attractive counterparties because risk transferred to a Tier 1 FHC will be in effect transferred to the federal government. Tier 1 FHCs will have a valuable asset (the implicit guarantee) that they can sell in quantities limited only by the Fed's oversight. They will have powerful incentives to find mechanisms—new financial products and creative off-balance-sheet devices—to evade any limits on the risks they can purchase from the remainder of the financial sector. And banks that are not Tier 1 FHCs will have similarly strong incentives to grow to the point that they become Tier 1 FHCs in order to guarantee access to bailout money. The fastest way to grow larger, of course, is to take bigger risks. Any institution that can keep its gains while transferring catastrophic losses to the government will find a way to engage in excessive risk-taking and expansion, and the financial system as a whole will suffer more frequent financial crises

This analysis is not meant to suggest that the current bankruptcy process cannot be improved or that it should work exactly the same for financial holding companies as it does for industrial corporations. Substantively, however, the resolution of financial holding companies should follow the same fundamental principle that creditors take losses in order of their

contractual priorities. The Lehman Brothers bankruptcy proceeding will undoubtedly provide lessons for resolving financial institutions more efficiently in the future. But a credible threat that failure will lead to a resolution proceeding in which the marginal loss will fall on creditors, not taxpayers, will do a better job of disciplining risk-taking than the combination of oversight and an implicit government guarantee.

Reducing Systemic Risk in the Financial Sector

Testimony of

Alice M. Rivlin

The Brookings Institution and Georgetown University

Committee on Financial Services

U.S. House of Representatives

July 21, 2009

Mr. Chairman and members of the Committee:

I am happy to be back before this Committee to give my views on reducing systemic risk in financial services. I will focus on changes in our regulatory structure that might prevent another catastrophic financial meltdown and what role the Federal Reserve should play in a new financial regulatory system.

It is hard to overstate the importance of the task facing this Committee. Market capitalism is a powerful system for enhancing human economic wellbeing and allocating savings to their most productive uses. But markets cannot be counted on to police themselves. Irrational herd behavior periodically produces rapid increases in asset values, lax lending and over-borrowing, excessive risk taking, and out-sized profits followed by crashing asset values, rapid deleveraging, risk aversion, and huge loses. Such a crash can dry up normal credit flows and undermine confidence, triggering deep recession and massive unemployment. When the financial system fails on the scale we have experienced recently the losers are not just the wealthy investors and executives of financial firms who took excessive risks. They are average people here and around the world whose jobs, livelihoods, and life savings are destroyed and whose futures are ruined by the effect of financial collapse on the world economy. We owe it to them to ferret out the flaws in the financial system and the failures of regulatory response that allowed this unnecessary crisis to happen and to mend the system so to reduce the chances that financial meltdowns imperil the world's economic wellbeing.

Approaches to Reducing Systemic Risk

The crisis was a financial "perfect storm" with multiple causes. Different explanations of why the system failed—each with some validity--point to at least three different approaches to reducing systemic risk in the future.

- **The highly interconnected system failed because no one was in charge of spotting the risks that could bring it down.**
  This explanation suggests creating a Macro System Stabilizer with broad responsibility for the whole financial system charged with spotting perverse incentives, regulatory gaps and market pressures that might destabilize the system and taking steps to fix them. The Obama Administration would create a Financial Services Oversight Council (an interagency group with its own staff) to perform this function. I think this responsibility should be lodged at the Fed and supported by a Council.
- **The system failed because expansive monetary policy and excessive leverage fueled a housing price bubble and an explosion of risky investments in asset backed securities.**
  While low interest rates contributed to the bubble, monetary policy has multiple objectives. It is often impossible to stabilize the economy and fight asset price bubbles with a single instrument. Hence, this explanation suggests stricter regulation of leverage throughout the financial system. Since monetary policy is an ineffective tool for controlling asset price bubbles, it should be supplemented by the power to change leverage ratios when there is evidence of an asset price bubble whose bursting that could destabilize the financial sector. Giving the Fed control of leverage would enhance the effectiveness of monetary policy. The tool should be exercised in consultation with a Financial Services Oversight Council.
- **The system crashed because large inter-connected financial firms failed as a result of taking excessive risks, and their failure affected other firms and markets.**
  This explanation might lead to policies to restrain the growth of large interconnected financial firms—or even break them up—and to expedited

resolution authority for large financial firms (including non-banks) to lessen the impact of their failure on the rest of the system. Some have argued for the creation of a single consolidated regulator with responsibility for all systemically important financial institutions. The Obama Administration proposes making the Fed the consolidated regulator of all Tier One Financial Institutions. I believe it would be a mistake to identify specific institutions as too big to fail and an even greater mistake to give this responsibility to the Fed. Making the Fed the consolidated prudential regulator of big interconnected institutions would weaken its focus on monetary policy and the overall stability of the financial system and could threaten its independence.

The Case for a Macro System Stabilizer

One reason that regulators failed to head off the recent crisis is that no one was explicitly charged with spotting the regulatory gaps and perverse incentives that had crept into our rapidly changing financial structure in recent decades. In recent years, anti-regulatory ideology kept the United States from modernizing the rules of the capitalist game in a period of intense financial innovation and perverse incentives to creep in.

Perverse incentives. Lax lending standards created the bad mortgages that were securitized into the toxic assets now weighting down the books of financial institutions. Lax lending standards by mortgage originators should have been spotted as a threat to stability by a Macro System Stabilizer—the Fed should have played this role and failed to do so—and corrected by tightening the rules (minimum down payments, documentation, proof that the borrow understands the terms of the loan and other no-brainers). Even more important, a Macro System Stabilizer should have focused on why the lenders had such irresistible incentives to push mortgages on people unlikely to repay. Perverse incentives were inherent in the originate-to-distribute model which left the originator with no incentive to examine the credit worthiness of the borrower. The problem was magnified as mortgage-backed securities were re-securitized into more complex

instruments and sold again and again. The Administration proposes fixing that system design flaw by requiring loan originators and securitizers to retain five percent of the risk of default. This seems to me too low, especially in a market boom, but it is the right idea.

The Macro System Stabilizer should also seek other reasons why securitization of asset-backed loans—long thought to be a benign way to spread the risk of individual loans—became a monster that brought the world financial system to its knees. Was it partly because the immediate fees earned by creating and selling more and more complex collateralized debt instruments were so tempting that this market would have exploded even if the originators retained a significant portion of the risk? If so, we need to change the reward structure for this activity so that fees are paid over a long enough period to reflect actual experience with the securities being created.

Other examples, of perverse incentives that contributed to the violence of the recent perfect financial storm include Structured Investment Vehicles (SIV's) that hid risks off balance sheets and had to be either jettisoned or brought back on balance sheet at great cost; incentives of rating agencies to produce excessively high ratings; and compensation structures of corporate executives that incented focus on short-term earnings at the expense the longer run profitability of the company.

The case for creating a new role of Macro System Stabilizer is that gaps in regulation and perverse incentives cannot be permanently corrected. Whatever new rules are adopted will become obsolete as financial innovation progresses and market participants find ways around the rules in the pursuit of profit. The Macro System Stabilizer should be constantly searching for gaps, weak links and perverse incentives serious enough to threaten the system. It should make its views public and work with other regulators and Congress to mitigate the problem.

The Treasury makes the case for a regulator with a broad mandate to collect information from all financial institutions and "identify emerging risks." It proposes putting that responsibility in a Financial Services Oversight Council, chaired by the Treasury, with its

own permanent expert staff. The Council seems to me likely to be cumbersome. Interagency councils are usually rife with turf battles and rarely get much done. I think the Fed should have the clear responsibility for spotting emerging risks and trying to head them off before it has to pump trillions into the system to avert disaster. The Fed should make a periodic report to the Congress on the stability of the financial system and possible threats to it. The Fed should consult regularly with the Treasury and other regulators (perhaps in a Financial Services Oversight Council), but should have the lead responsibility. Spotting emerging risks would fit naturally with the Fed's efforts to monitor the state of the economy and the health of the financial sector in order to set and implement monetary policy. Having explicit responsibility for monitoring systemic risk—and more information on which to base judgments would enhance its effectiveness as a central bank.

Controlling Leverage. The biggest challenge to restructuring the incentives is: How to avoid excessive leverage that magnified the upswing and turned the downswing into a rout? The aspect of the recent financial extravaganza that made it truly lethal was the over-leveraged superstructure of complex derivatives erected on the shaky foundation of America's housing prices. By itself, the housing boom and bust would have created distress in the residential construction, real estate, and mortgage lending sectors, as well as consumer durables and other housing related markets, but would not have tanked the economy. What did us in was the credit crunch that followed the collapse of the highly leveraged financial superstructure that pumped money into the housing sector and became a bloated monster.

One approach to controlling serious asset–price bubbles fueled by leverage would be to give the Fed the responsibility for creating a bubble Threat Warning System that would trigger changes in permissible leverage ratios across financial institutions. The warnings would be public like hurricane or terrorist threat warnings. When the threat was high—as demonstrated by rapid price increases in an important class of assets, such as land, housing, equities, and other securities without an underlying economic justification--the Fed would raise the threat level from, say, Three to Four

or Yellow to Orange. Investors and financial institutions would be required to put in more of their own money or sell assets to meet the requirements. As the threat moderated, the Fed would reduce the warning level.

The Fed already has the power to set margin requirements—the percentage of his own money that an investor is required to put up to buy a stock if he is borrowing the rest from his broker. Policy makers in the 1930s, seeking to avoid repetition of the stock price bubble that preceded the 1929 crash, perceived that much of the stock market bubble of the late 1920s had been financed with money borrowed on margin from broker dealers and that the Fed needed a tool distinct from monetary policy to control such borrowing in the future.

During the stock market bubble of the late 1990s, when I was Vice Chair of the Fed's Board of Governors, we talked briefly about raising the margin requirement, but realized that the whole financial system had changed dramatically since the 1920s. Stock market investors in the 1990s had many sources of funds other than borrowing on margin. While raising the margin requirements would have been primarily symbolic, I believe with hindsight that we should have done it anyway in hopes of showing that we were worried about the bubble.

The 1930's legislators were correct: monetary policy is a poor instrument for counteracting asset price bubbles; controlling leverage is likely to be more effective. The Fed has been criticized for not raising interest rates in 1998 and the first half of 1999 to discourage the accelerating tech stock bubble. But it would have had to raise rates dramatically to slow the market's upward momentum—a move that conditions in the general economy did not justify. Productivity growth was increasing, inflation was benign and responding to the Asian financial crisis argued for lowering rates, not raising them. Similarly, the Fed might have raised rates from their extremely low levels in 2003 or raised them earlier and more steeply in 2004-5 to discourage the nascent housing price bubble. But such action would have been regarded as a bizarre attempt to abort the economy's still slow recovery. At the time

there was little understanding of the extent to which the highly leveraged financial superstructure was building on the collective delusion that U.S. housing prices could not fall. Even with hindsight, controlling leverage (along with stricter regulation of mortgage lending standards) would have been a more effective response to the housing bubble than raising interest rates. But regulators lacked the tools to control excessive leverage across the financial system.

In the wake of the current crisis, financial system reformers have approached the leverage control problem in pieces, which is appropriate since financial institutions play diverse roles. However the Federal Reserve—as Macro System Stabilizer—could be given the power to tie the system together so that various kinds of leverage ratios move in the same direction simultaneously as the threat changes.

With respect to large commercial banks and other systemically important financial institutions, for example, there is emerging consensus that higher capital ratios would have helped them weather the recent crisis, that capital requirements should be higher for larger, more interconnected institutions than for smaller, less interconnected ones, and that these requirements should rise as the systemic threat level (often associated with asset price bubbles) goes up.

With respect to hedge funds and other private investment funds, there is also emerging consensus that they should be more transparent and that financial derivatives should be traded on regulated exchanges or at least cleared on clearinghouses. But such funds might also be subject to leverage limitations that would move with the perceived threat level and could disappear if the threat were low.

One could also tie asset securitization into this system. The percent of risk that the originator or securitizer was required to retain could vary with the perceived threat of an asset price bubble. This percentage could be low most of the time, but rise

automatically if Macro System Stabilizer deemed the threat of a major asset price bubble was high. One might even apply the system to rating agencies. In addition to requiring rating agencies to be more transparent about their methods and assumptions, they might be subjected to extra scrutiny or requirements when the bubble threat level was high.

Designing and coordinating such a leverage control system would not be an easy thing to do. It would require create thinking and care not to introduce new loopholes and perverse incentives. Nevertheless, it holds hope for avoiding the run away asset price exuberance that leads to financial disaster.

Systemically Important Institutions

The Obama Administration has proposed that there should be a consolidated prudential regulator of large interconnected financial institutions (Tier One Financial Holding Companies) and that this responsibility be given to the Federal Reserve. I think this is the wrong way to go.

It is certainly important to reduce the risk that large interconnected institutions fail as a result of engaging in highly risky behavior and that the contagion of their failure brings down others. However, there are at least three reasons for questioning the wisdom of identifying a specific list of such institutions and giving them their own consolidated regulator and set of regulations. First, as the current crisis has amply illustrated, it is very difficult to identify in advance institutions that pose systemic risk. The regulatory system that failed us was based on the premise that commercial banks and thrift institutions that take deposits and make loans should be subject to prudential regulation because their deposits are insured by the federal government and they can borrow from the Federal Reserve if they get into trouble. But in this crisis, not only did the regulators fail to prevent excessive risk-taking by depository institutions, especially thrifts, but systemic threats came from other quarters. Bear Stearns and Lehman Brothers had no insured deposits and no claim on the resources of the Federal Reserve. Yet when they made stupid decisions and were on the edge of failure the authorities realized they were just as

much a threat to the system as commercial banks and thrifts. So was the insurance giant, AIG, and, in an earlier decade, the large hedge fund, LTCM. It is hard to identify a systemically important institution until it is on the point of bringing the system down and then it may be too late.

Second, if we visibly cordon off the systemically important institutions and set stricter rules for them than for other financial institutions, we will drive risky behavior outside the strictly regulated cordon. The next systemic crisis will then likely come from outside the ring, as it came this time from outside the cordon of commercial banks.

Third, identifying systemically important institutions and giving them their own consolidated regulator tends to institutionalize 'Too Big to Fail' and create a new set of GSE-like institutions. There is a risk that the consolidated regulator will see its job as not allowing any of its charges to go down the tubes and is prepared to put taxpayer money at risk to prevent such failures.

Higher capital requirements and stricter regulations for large interconnected institutions make sense, but I would favor a continuum rather than a defined list of institutions with its own special regulator. Since there is no obvious place to put such a responsibility, I think we should seriously consider creating a new financial regulator. This new institution could be similar to the UK's FSA, but structured to be more effective than the FSA proved in the current crisis. In the US one might start by creating a new consolidated regulator of all financial holding companies. It should be an independent agency but might report to a board composed of other regulators, similar to the Treasury proposal for a Council for Financial Oversight. As the system evolves the consolidated regulator might also subsume the functional regulation of nationally chartered banks, the prudential regulation of broker-dealers and nationally chartered insurance companies.

I don't pretend to have a definitive answer to how the regulatory boxes should best be arranged, but it seems to me a mistake to give the Federal Reserve responsibility for consolidated prudential regulation of Tier One Financial Holding Companies, as

proposed by the Obama Administration. I believe the skills needed by an effective central bank are quite different from those needed to be an effective financial institution regulator. Moreover, the regulatory responsibility would likely grow with time, distract the Fed from its central banking functions, and invite political interference that would eventually threaten the independence of monetary policy.

Especially in recent decades, the Federal Reserve has been a successful and widely respected central bank. It has been led by a series of strong macro economists—Paul Volcker, Alan Greenspan, Ben Bernanke—who have been skillful at reading the ups and downs of the economy and steering a monetary policy course that contained inflation and fostered sustainable economic growth. It has played its role as banker to the banks and lender of last resort—including aggressive action with little used tools in the crisis of 2008-9. It has kept the payments system functioning even in crises such as 9/11, and worked effectively with other central banks to coordinate responses to credit crunches, especially the current one. Populist resentment of the Fed's control of monetary policy has faded as understanding of the importance of having an independent institution to contain inflation has grown—and the Fed has been more transparent about its objectives. Although respect for the Fed's monetary policy has grown in recent years, its regulatory role has diminished. As regulator of Bank Holding Companies, it did not distinguish itself in the run up to the current crisis (nor did other regulators). It missed the threat posed by the deterioration of mortgage lending standards and the growth of complex derivatives.

If the Fed were to take on the role of consolidated prudential regulator of Tier One Financial Holding Companies, it would need strong, committed leadership with regulatory skills—lawyers, not economists. This is not a job for which you would look to a Volcker, Greenspan or Bernanke. Moreover, the regulatory responsibility would likely grow as it became clear that the number and type of systemically important institutions was increasing. My fear is that a bifurcated Fed would be less effective and less respected in monetary policy. Moreover, the concentration of that much power in an institution would rightly make the Congress nervous unless it exercised more oversight

and accountability. The Congress would understandably seek to appropriate the Fed's budget and require more reporting and accounting. This is not necessarily bad, but it could result in more Congressional interference with monetary policy, which could threaten the Fed's effectiveness and credibility in containing inflation.

In summary, Mr. Chairman: I believe that we need an agency with specific responsibility for spotting regulatory gaps, perverse incentives, and building market pressures that could pose serious threats to the stability of the financial system. I would give the Federal Reserve clear responsibility for Macro System Stability, reporting periodically to Congress and coordinating with a Financial System Oversight Council. I would also give the Fed new powers to control leverage across the system—again in coordination with the Council. I would not create a special regulator for Tier One Financial Holding Companies, and I would certainly not give that responsibility to the Fed, lest it become a less effective and less independent central bank.

Thank you, Mr. Chairman and members of the Committee.

Testimony

Before the House Financial Services Committee

July 21, 2009

Peter J. Wallison

Arthur F. Burns Fellow in Financial Policy Studies

American Enterprise Institute

Mr. Chairman, Ranking Member Bachus, and members of the Committee:

The Committee has asked the witness today to address a single question: Are some institutions too big to fail and if so what should we do about it? In this testimony I will address those two questions.

Are some institutions too big to fail?

The answer to that question is yes, but as discussed below those institutions are only large commercial banks.

When we say that a company is too big to fail (TBTF), we mean that if it fails it will cause damage to the financial system as a whole—in other words, that its failure will cause many other companies to be seriously weakened or forced into bankruptcy. One of the problems associated with attempting to prevent a systemic breakdown is that it is difficult to determine, in advance, whether the failure of a particular company will cause a systemic breakdown or merely a temporary disruption. For the same reason, it is very difficult to determine, in advance, when a company is TBTF.

Nevertheless, it is important to distinguish between failures that will cause disruption and those that will cause a systemic breakdown of some kind. We should not want to rescue firms from failure if their bankruptcy would only create a temporary disruption in the economy. Those companies should not be regarded as TBTF. If we embarked on a path that would rescue all large firms, because their failure would cause economic disruption, we would create moral hazard. Market discipline would be impaired as creditors thought that they would be rescued by the government. Bad managements and bad business models would be preserved—when, in reality, they should disappear to make room for new and better managements and business models. That's how innovation, efficiency and change occur in our economy.

In theory, however, it is possible to visualize how the failure of a large bank might have more than simply a disruptive effect. Companies deposit their payrolls in banks pending use; individuals deposit funds in banks in order to pay their bills and their mortgages; and small banks deposit funds in large banks as part of the payment system. So when a large bank fails there could be a cascade of immediate losses through the economy. If this happens, companies will not be able to meet their payrolls, individuals will not be able to pay their mortgages, and smaller banks will not be able to meet their obligations to pay out the funds that are withdrawable on demand. In other words, the failure of a large bank can cause a cascade of losses and failures through the economy that might qualify as a systemic breakdown—that is, something more than a mere temporary disruption.

Can a nonbank financial institution create systemic risk and thus be TBTF? On the other hand, it is very difficult to see how a *nonbank* financial institution like a bank holding company, insurance company, securities firm, finance company or hedge fund—no matter what its size—can cause a systemic breakdown or become TBTF. Using a bank holding company (BHC) as an example, it's useful to consider what would happen if a large nonbank financial institution like that were to fail. Importantly, its liabilities are not deposits, and are not withdrawable on

demand. As a result, if it fails, very few of its creditors suffer any immediate cash losses. No business, for example, deposits its payroll with a BHC. The BHC may have short term creditors, but unless it's a very financially strong company these short term obligations are likely to be collateralized, and thus short term creditors can make themselves whole by selling their collateral. Most of a BHC's creditors are long term, however, and they will suffer a loss over time. Of course, if the company defaults on any of its debts, all its obligations will usually come due because of cross-default provisions in its outstanding borrowings, and it will thus be forced into bankruptcy. This does not change the condition of long-term creditors; they simply now get in line to receive their share of the bankrupt company's assets, or they approve a plan of reorganization that returns the company to viability if they believe the company will eventually be able to pay them back.

But, still, how does a BHC's bankruptcy create a systemic breakdown? If most of its short-term creditors are made whole through the collateral they hold, and its long-term creditors will eventually take losses as the company goes through bankruptcy, it's not obvious that a systemic breakdown can occur. Even if the long-term creditors take losses, these losses occur over time; they will not be the immediate cash losses that occur when a bank fails. Moreover, the BHC's creditors are very likely to be institutions whose lending is widely diversified. They will lick their wounds, but will not be forced into bankruptcy because of the failure of the bank holding company. They will continue functioning. There would be no systemic breakdown.

Moreover, there is no evidence—none—that credit default swaps (CDS) or other derivatives had anything to do with what happened after Lehman, or that if AIG had been allowed to fail there would have been a catastrophic effect on the financial markets. Lehman's CDS were all cleaned up after its bankruptcy for a total of $5.2 billion exchanged among the various counterparties. Goldman Sachs was the largest CDS counterparty of AIG, with contracts valued at $12.9 billion. But when a spokesman for Goldman was asked what would have been the effect on Goldman if AIG had failed, the answer was that the effect would have been "negligible." As required in most CDS contracts, Goldman had received collateral from AIG before its rescue and had also hedged its AIG exposure. If Goldman, AIG's largest counterparty, would not have suffered significant losses, there is no reason to believe that anyone else would have suffered systemically significant losses either. After all, AIG's CDS—like all CDS—were simply like insurance or reimbursement contracts, with AIG in the position of the insurer. If AIG had failed, its counterparties—like the homeowner whose insurance company fails before he has a loss on his home—would have been required to find another insurer, but they would not have suffered any major loss.

Finally, we read all the time that financial companies are "interconnected," and that's the reason they must be treated specially. It's certainly true that financial firms are interconnected in some sense—that's the nature of financial firms, which are in the business of moving money from a place where it's not well-used to a place where it is better employed. To accomplish that, interconnections are necessary. But the question is not whether these firms are interconnected; it is whether these interconnections create cross-obligations that are so large as to make it probable that if one nonbank financial firm fails it will bring others down with it. There is no evidence for this, and it is highly unlikely for the reasons stated above. After Lehman failed, for example, there was only one case of another company encountering trouble. In that case, a money market

mutual fund (the Reserve Fund) was unable to maintain the value of its shares at one dollar, and suffered a run. But beyond that, there is no indication that any other firm suffered serious losses as a result of Lehman's failure. Even the CDSs on Lehman, as noted above, were quickly settled with no known adverse effects.

I should add here, as an aside, that our banking laws have been structured so that the failure of a bank holding company should have no effect on the underlying bank or banks. It's simply the failure of a bank's shareholder. Banks are restricted by banking law and regulations from making loans of significant size to their parent company or affiliates, so that the bank is insulated from the failure of the holding company. The reason is that the holding company is or could be engaged in activities that are riskier than the activities of a bank, and is more likely to fail for that reason. Many on the committee will remember that this restriction was put in place to prevent the extension of the so-called "federal safety net" beyond banks themselves. It is ironic that the administration is now proposing to extend a safety net to the same companies that were not supposed to cost the government anything.

The important point, however, is that if a BHC fails there are very few immediate cash losses that render its creditors unable to meet their own obligations, and thus no cascade of losses through the economy. So if we define a systemic event as a kind of contagion in which the losses of one company spread to others and affect the whole economy, it seems that only the failure of a large bank can have this effect. In other words, in my view, only a large bank can be too big to fail.

The Lehman case. Having said this, there is one category of events that is frequently called a systemic breakdown but is not. Here I am referring to the kind of turmoil that occurred after the failure of Lehman Brothers in September 2008. In that case, there was an immediate freeze-up of lending by banks and other financial intermediaries around the world. Because no direct losses are known to have occurred as a result of Lehman's failure (except the Reserve Fund as described above), this was not a classic case of a systemic breakdown in which losses were transmitted through an economy or financial system. What happened after Lehman Brothers' failure is what is known as a "common shock"—an event that causes a market to stop functioning because the participants have encountered new information that nullifies their previous expectations about the future. In this case, in a classic example of moral hazard, market participants were shocked to learn that—despite the rescue of Bear Stearns the preceding March—the government did not intend to rescue every firm that was larger than Bear. This new and highly adverse information required all market participants to reassess whether their counterparties and borrowers were solvent and safe, since a government rescue could no longer be considered a near certainty. The result was a freeze-up in lending as every major institution hoarded cash while it reassessed the financial condition of its counterparties.

A market freeze-up that results from a common shock is not the same thing as a systemic event and can't be prevented by the regulation of individual institutions. It is the result of a loss of confidence in the future by market participants as a group, not the failure of a particular institution. In reality, there were two common shocks that led to the current crisis. The first was the recognition by market participants in the summer of 2007 that defaults on U.S. mortgages were much higher than expected and mortgage-backed securities backed by these mortgages and

rated AAA were not nearly as safe as previously thought. This led to the downgrading of mortgage securities portfolios, the shutdown of the asset-backed securities market, and large financial losses at banks because of the influence of mark-to-market accounting. The second shock was the failure of Lehman. It is highly unlikely that the second shock would not have had the adverse effect that it did without (i) the prior rescue of Bear Stearns, which made Lehman's failure a shock, and (ii) the weakening of bank capital positions because of the shutdown of the asset backed market in mid-2007 and the resulting sharp loss in the value of asset-backed securities.

Bank regulation failed to prevent the losses at individual banks because neither the banks nor their supervisors recognized that the assets they were acquiring in the form of mortgage-backed securities (MBS) and other asset-backed securities (ABS) were not of AAA quality, and that the market for these securities would completely dry up when the poor quality of these securities became known. Even more important, there was no general recognition anywhere in the system that virtually all the world's major banks were buying and holding the same weak assets. This made them all subject to the same effect when the first shock—the loss of value for MBS and ABS—occurred in mid-2007. Once all these institutions were weakened at the same time, they became vulnerable to any shock that caused a sharp loss of confidence about the future. Lehman was that shock.

The crises of the past did not result in similar global financial collapses because most financial institutions were considered adequately capitalized and financially strong enough to survive a substantial change in circumstances. Accordingly, the failure of the large securities firm Drexel Burnham Lambert in 1990, the collapse of the Thai Baht and the Russian default later in that decade, and the failure of Penn Central and the relatively small Herstatt bank in the 1970s, all caused major disruptions in the financial markets when they occurred, but none caused a global financial meltdown. However, once all or almost all major banks are perceived as weak and unstable—as they were in 2008—anything that shook market confidence and disrupted expectations would have had the same effect as Lehman's failure. This would include a major earthquake in the United States, the collapse of the government of a major oil exporting nation, or some other natural or unexpected catastrophe that causes market participants to recalibrate who is safe to deal with and who is not.

This leads to the conclusion that if we are to prevent a financial crisis in the future we should take steps to prevent virtually all major banks from taking on the same risks and becoming weak at the same time. To carry out this policy, it will be necessary to recognize in advance that the elements for a severe common shock are coming together. Thus, in order to prevent a recurrence of the financial crisis, the regulation of commercial banks should focus not only the safety and soundness of the individual bank, but also on safety and soundness of the banking system as a whole. In this way, we can minimize the chances that the failure of a large bank will create a systemic event, and the chances that the banking system as a whole will become so weak that any Lehman-like common shock will cause a financial meltdown. As outlined below, then, we should adopt a form of what might be called macro-prudential regulation.

This strategy also avoids the negative effects on economic growth that would flow from regulating nonbank financial institutions the way we regulate banks. These nonbank institutions are not backed by the federal government, and are still controlled by market discipline. Placing them under government regulation, as the administration proposes, would create moral hazard and give them substantial funding advantages over their smaller competitors. It would be like creating Fannie Maes and Freddie Macs in every sector of the financial economy where these institutions are designated for special regulatory treatment. Even more important, as distinguished from banks, these institutions are supposed to be risk-takers; they are supposed to fail at higher rates than commercial banks. There is no reason to keep them from failing. If we were to regulate all these institutions the way we regulate commercial banks we would suppress the risk-taking that drives growth and innovation in our economy.

If large commercial banks are too big to fail, what should we do about it?

Once we focus on large banks as the most likely sources of systemic risk—and as a bulwark against devastating common shocks—there are a number of steps we can take. These are generally of two kinds: first, to create a means for discovering conditions in the financial markets that might make the financial system vulnerable to a common shock; and, second, to place supervisory limits on banks that will (i) restrict their risk-taking, (ii) limit the their procyclical tendency to lend freely when asset prices are rising, and (ii) ensure that they have the capital to remain strong when the inevitable asset bubbles deflate.

1. *A systemic risk council.* As outlined above, one of the reasons for the current crisis is that virtually all large banks held the same weak assets—weak because they were not of high quality themselves and were subject to rapid devaluation if the market for them disappeared.. One way to address this problem would be to authorize some regulatory body to monitor the worldwide financial system and report to Congress and the public on the possible growth of systemic risk or the factors that might produce a serious common shock. A suitable body for this purpose would be the President's Working Group, reconstituted as a Systemic Risk Council. The Council, which would have a small staff of its own, would be able to use the combined knowledge of the bank regulators, as well as the SEC and the CFTC, to broaden its perspective on the markets.

2. *Metrics of risk-taking.* The bank supervisors, working with banks and bank analysts, should develop metrics and indicators of risk-taking that all banks would be required to publish regularly. One of the continuing functions of supervisors would be to assure that these metrics were kept up to date and consistently calculated and reported by the banks under their supervision. If properly designed, metrics of risk-taking would signal when a bank is holding assets that are subject to sharp declines in values, assets that are highly correlated with assets held by other banks, or that a bank is relying excessively on short term liabilities to fund long term assets. Regular publication of these metrics would enhance market discipline by alerting creditors more effectively to bank risk-taking.

3. *Subordinated debt.* The largest banks should be required to issue subordinated debt that by law could not be bailed out by the government. If the interest rate on these instruments

were to rise substantially above the rate on Treasury securities, it would signal to regulators that the market perceives excessive risk-taking in the issuer bank.

4. *Higher capital requirements for banks.* We could require very large banks to reconsider the benefits of size by imposing higher capital requirements as banks grow above a certain level. In this way, the largest banks would be protecting themselves and the financial system against the possibility of their own failure, and would also have a strong financial incentive not to grow larger.

5. *Countercyclical capital increases and other measures.* We could put in place regulatory requirements that would operate countercyclically, tending to restrain bank growth when asset prices are rising and cushion bank losses when asset prices are falling. For example, requiring higher reserves or capital levels as asset values rise would accomplish this. Eventually, those values will deflate, and at that time we want banks to have enough capital cushions so that market confidence in their health is not eroded. Capital requirements could also be increased if a bank's ratio of short term liabilities to long term assets rises above a predetermined level. This would tend to discourage banks from borrowing short term in the money markets in order to profit from the spread between short term money costs and the returns on long term assets. This would reduce the tendency of banks to act procyclically in fostering asset bubbles.

6. *Countercyclical macro-prudential measures.* The Systemic Risk Council could be authorized to establish an acceptable level of bank growth and impose appropriate limits on growth that are not consistent with these limits. For example, the council could impose a higher leverage ratio on banks when it appears that asset prices have risen too quickly. The leverage ratio for U.S. banks is defined as total common equity divided by total assets. Well capitalized banks must maintain a leverage ratio of 5%; the minimum is 3%. Raising the bank leverage ratio would require banks to sell assets or restrict lending, which would tend to mitigate the growth of asset bubbles. This would be a more direct way of limiting bank contributions to asset bubbles than expecting the Fed to raise interest rates.

If these measures were put in place, and coupled solely with a focus on large commercial banks, we would minimize the likelihood of another financial crisis while maintaining the dynamism and risk-taking that economic growth requires.

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

Before the House Financial Services Committee

"Systemic Risk: Are Some Institutions too Big to Fail, and if so, What Should We Do About It?"

July 21, 2009

At its most fundamental level, the current economic calamity was precipitated by trillions of dollars in bad loans made in the lending frenzy during the middle of this decade. Between 2005 and 2007, the U.S. financial system extended too much credit to too many households and to a fair number of businesses that simply could not make good on those loans if they suffered even the mildest of financial setbacks. And there were plenty of setbacks, resulting in a flood of bad loans and losses to the financial system that undermined the system's capital base and thus its ability to extend credit even to creditworthy borrowers. As the credit spigot closed, it choked off economic activity, causing millions to lose their jobs and causing profits to plunge, thus creating even more bad loans, more losses, and an even larger capital shortfall. This adverse self-reinforcing cycle is at the center of the worst economic and financial crisis since the Great Depression.

Policymakers have worked aggressively to short-circuit this cycle, stabilize the financial system, and get credit flowing again. The U.S. Treasury Department has taken equity stakes in many of the nation's large financial institutions and has all but nationalized the residential mortgage market by placing Fannie Mae and Freddie Mac in conservatorship and empowering the FHA to dramatically expand its lending. The Federal Reserve has slashed the federal funds rate to zero and has stepped into the lending breach by purchasing a wide range of securities and extending cheap credit to private investors. The Treasury and Fed have put the nation's largest banks through stress tests to force them to rebuild capital sufficient to withstand future economic storms. And the Treasury is forming partnerships with large investors to purchase troubled securities from banks, providing a mechanism for removing them from their balance sheets.

All this will be very costly for taxpayers. The government has committed an astonishing $12 trillion to quell the crisis, of which $4 trillion has been provided (see Table 1). This includes money from the Troubled Asset Relief Program or TARP, the capital needed to shore up Fannie Mae and Freddie Mac, and losses the FDIC and FHA will bear given their added responsibilities. The ultimate cost to taxpayers will be less, since some of the money will be recouped in future asset sales, but the final tab is expected to approach $1.2 trillion, equal to over 8% of GDP.[i]

Although this is an extraordinary amount, taxpayers would have done measurably worse if policymakers had not acted so aggressively. The policy steps taken so far are working. The panic that roiled financial markets last fall and early this year is fading. A great deal of angst remains, but credit spreads—the best measure of that angst—have narrowed significantly. Bond issuance has revived, even for below-investment-grade corporations. Stock prices are up substantially from their early-March lows, even for banks issuing new equity following the stress tests. Perhaps most encouraging is that interbank lending, which had effectively shut down late last year, has largely returned to normal. Thus, while credit remains significantly impaired, it is measurably more ample than it was just a few weeks ago and much cheaper. There is no better reason to be hopeful that the worst of the economic downturn is over.

Table 1: Government Response to Financial Crisis
$ bil

	Pledged	Provided
Total	**12,080**	**4,036**
Federal Reserve		
Term auction credit	900	428
Other loans	Unlimited	132
Primary credit	Unlimited	42
Secondary credit	Unlimited	0
Seasonal credit	Unlimited	0
Primary Dealer Credit Facility	Unlimited	0
Asset-Backed Commercial Paper Money Market Mutual Fund	Unlimited	29
AIG	46	46
AIG (for SPVs)	9	0
AIG (for ALICO, AIA)	26	0
Rescue of Bear Stearns (Maiden Lane)**	27	26
AIG-RMBS purchase program (Maiden Lane II)**	23	16
AIG-CDO purchase program (Maiden Lane III)**	30	20
Term Securities Lending Facility	200	14
Commercial Paper Funding Facility**	1,800	163
TALF	1,000	16
Money Market Investor Funding Facility	540	0
Currency swap lines	Unlimited	247
Purchase of GSE debt and MBS	1,250	504
Guarantee of Citigroup assets	286	0
Guarantee of Bank of America assets	108	0
Purchase of long-term Treasuries	300	102
Treasury		
TARP	700	570
Fed supplementary financing account	479	479
Backstop of Fannie Mae and Freddie Mac	400	0
Federal Deposit Insurance Corporation		
Guarantee of U.S. banks' debt*	1,400	349
Guarantee of Citigroup assets		10
Guarantee of Bank of America assets		2.5
Transaction deposit accounts	500	0
Public-Private Investment Fund Guarantee	1,000	0
Federal Housing Administration		
Refinancing of mortgages	100	0
Congress		
Economic Stimulus Act of 2008	170	170
American Recovery and Reinvestment Act of 2009	787	787

Sources: Fed, Treasury, FDIC, FHA, Moody's Economy.com
*Includes foreign denominated debt
**Net portfolio holdings

This is not to say that credit flows will normalize soon or that the recession will soon give way to a robust recovery. Indeed, the coming recovery will be muted as long as the government has to prop up the nation's financial institutions. These institutions cannot yet provide enough credit to power strong and consistent growth. The financial system has a long way to go before it will be able to do without taxpayer help. Hundreds of smaller institutions that are not too big to fail will, and big parts of the securities markets have to be completely reworked before they can operate effectively again. Even when the government is able to step away from the financial system, private risk capital will be reluctant to return as long as the memory of recent events lasts, probably for a generation. Such risk capital fuels the innovation and technological change so vital to the economy's underlying productivity growth and long-term prospects.

The government's vast intrusion into the financial system also poses a range of threats. There are legitimate worries that with the Federal Reserve pumping so much liquidity into the system, it will eventually ignite undesirably high, if not runaway, inflation. Moreover, it is not clear whether the government will be able to gracefully exit its large ownership stakes in Fannie and Freddie, banks, and other financial firms. Fortunately, calls to nationalize major financial institutions, which would make such an exit significantly more complicated, have not been heeded.

The financial crisis also presents a once-in-a-lifetime opportunity to reform the regulatory framework overseeing the financial system. The Obama administration's proposed financial regulatory reform is much-needed and reasonably well-designed. Regulatory reform is vital to restoring confidence in the financial system and thus fully reviving it and the economy. The administration's proposed regulatory framework fills most of the holes in the current one, and although it would not have prevented the current crisis, it would have made it less severe. More importantly, the proposed framework would reduce the odds and severity of future financial crises.

The financial panic and Great Recession may soon be history, but its repercussions will be felt for decades.

Loss accounting

Millions of bad loans were made during the middle of this decade. At the time of their origination, there was a high probability that borrowers would be unable to make timely payments even under relatively untroubled financial scenarios.

More than 12.5 million subprime, alt-A, and jumbo residential mortgage loans were originated between 2005 and 2007, the height of the housing bubble. By the end of 2007, these risky loans accounted for nearly a fourth of all first mortgage loans outstanding. Adding to the threat that homeowners with these loans might never make good on them, almost half were so-called stated income loans—for which borrowers did not have to provide W-2 forms or tax returns to document their income. Over half of these borrowers also took out second mortgages, thus putting little or nothing down on their homes. Bad lending practices extended beyond residential mortgages to auto and credit card loans, commercial mortgages, corporate bonds, and leveraged loans used to finance increasingly aggressive private equity deals.

The ultimate cost of all this bad lending is projected to be an astounding $2.6 trillion (see Table 2). This translates into a cumulative lifetime loss rate of well over 10% on the approximately $24 trillion in U.S. credit market instruments now outstanding. The projection is based on a range of other forecasts, including an expected peak-to-trough decline in real estate prices of nearly 40% and a peak unemployment rate of 10%. Of these expected credit losses, $1.2 trillion will be suffered by depository institutions; nearly $1 trillion by pension funds, insurance companies, hedge funds and mutual funds; and $350 billion by government-sponsored enterprises including Fannie Mae, Freddie Mac and the FHA (see Chart 1).

To date, financial institutions have recognized some $1.4 trillion of the $2.6 trillion in expected losses (see Table 3). This suggests the system faces another $1.2 trillion in write-downs. Of these, about half, or $600 billion, will be taken by U.S.-based institutions. The rest will be borne by overseas institutions, mostly in Europe.

Table 2: Cumulative Lifetime Losses on Unsecuritized Loans and Securities in U.S. Financial System as of Year-End 2008
$ bil

	Face Value	Expected Losses	Loss Rate	Expected Losses: Banks	Insurance	Pension Funds	GSEs and Government	Hedge Funds and Mutual Funds
Residential Mortgages	10,856	1,339	12.3	550	205	145	321	118
Consumer Credit	2,025	262	12.9	167	38	16	-	41
Commercial Real Estate	3,425	471	13.8	250	74	59	30	58
Corporate	7,835	491	6.3	284	79	61	-	67
Total	24,141	2,563	10.6	1,251	396	281	351	284

Cash Flow Losses on Unsecuritized Loans
$ bil

	Face Value	Expected Losses		Expected Losses: Banks	Insurance	Pension Funds	GSEs and Government	Hedge Funds and Mutual Funds
Subprime	320	123	38.4	63	11	6	29	14
Alt-A	605	142	23.5	53	8	4	69	8
Prime	3,850	139	3.6	54	11	7	59	8
Commercial Real Estate	2,475	245	9.9	149	36	28	5	27
Consumer Loans	1,400	189	13.5	129	23	12	-	25
Corporate Loans	3,700	155	4.2	113	11	9	-	22
Leveraged Loans	175	45	25.7	25	6	6	-	8
Total Loans	12,525	1,038	8.3	586	106	72	162	112

Mark-to-Market Losses on Securities Holdings
$ bil

	Face Value	Expected Losses		Expected Losses: Banks	Insurance	Pension Funds	GSEs and Government	Hedge Funds and Mutual Funds
Subprime Residential	701	250	35.7	123	41	32	16	38
Alt-A Residential	870	205	23.6	68	28	15	84	10
Jumbo Residential	310	20	6.5	6	6	3	3	2
ABS CDOs	400	361	90.3	178	82	47	22	32
Prime MBS	3,800	99	2.6	5	18	31	39	6
CMBS	950	226	23.8	101	38	31	25	31
Consumer ABS	625	73	11.7	38	15	4	-	16
High-Grade Corporate Debt	3,010	133	4.4	69	28	27	-	9
High-Yield Corporate Debt	605	81	13.4	37	22	11	-	11
CLOs	345	77	22.3	40	12	8	-	17
Total Securities	11,616	1,525	13.1	665	290	209	189	172

Source: Moody's Economy.com

Chart 1: Big Losses Across All Financial Institutions
Projected losses on U.S. credit market instruments, $ bil

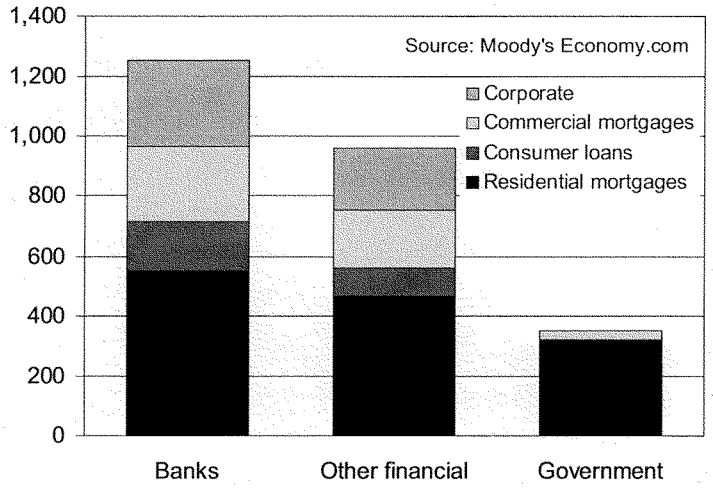


Table 3: Top 25 Financial Institution Write-Downs Taken on U.S. Loans and Securities
$ bil

Wachovia	101.9
Citi	101.8
Bank of America	56.6
Merrill Lynch	55.9
UBS	53.1
Washington Mutual	45.3
HSBC	42.2
JP Morgan	41.1
RBS	29.5
Wells Fargo	27.9
HBOS Plc	27.2
National City	25.2
Morgan Stanley	22.7
Barclays	18.6
Deutsche Bank	18.3
Credit Suisse	17.2
Lehman Brothers	16.2
Bayerische Landesbank	16.0
ING	15.4
IKB Deutsche	13.8
BNP Paribas	13.7
PNC	12.4
KBC Groep NV	11.3
Bank of China	11.2
Societe Generale	11.1

Source: Bloomberg

Who is to blame?

There is plenty of blame to go around for the bad lending. Most obviously, it could not have occurred without someone providing the credit, and flush global investors obliged. Booming emerging economies such as China and Russia collected a surfeit of dollars from their lopsided trade with the U.S. These countries invested initially in risk-free U.S. Treasuries, but in a quest for greater returns, they eventually moved into riskier mortgage and other securities. With hundreds of billions to invest and little time in which to do it, emerging market investors did little or no research of their own.

The U.S. financial system funneled dollars from global investors into loans to U.S. households and businesses via the process of securitization. It turned out that this process was fundamentally broken. No one involved—from the mortgage firms that originated the loans to the investment banks that packaged them into securities to the rating agencies that graded those securities to the global investors themselves—made sure the loans were good. Everyone in this complex process thought others were doing so, but no one was. Securitization was guided by a mélange of laws, regulations and accounting rules, supposedly designed to prevent bad lending, but the tide of investor dollars completely overwhelmed the process. There was too much money to be made by all involved.

Regulators could have intervened but did not. The middle of the decade marked the apex of a quarter-century of financial deregulation that began in earnest during the Reagan administration. Back in the early 1980s, deregulation was desirable; many lower- and middle-income households and small and even midsized businesses could not obtain credit or could get it only at a high price. But by the middle of the decade, deregulatory fervor had gone much too far. Even at the Federal Reserve—the nation's key banking regulator—there was a view that self-interested global investors would do their own policing; regulators would only muck up an efficient lending process. This view was misplaced, as lending became increasingly egregious.

Hubris fueled runaway lending. House "flippers" were empowered by lenders' belief that house prices would never fall. Lenders, investment banks and rating agencies thought their data and models were sophisticated enough to prevent major mistakes. Investors thought the wild business-cycle swings of the past were just that—history. Central bankers believed that even if things did not go as planned, they could deftly step in and limit any economic fallout. This overconfidence bred greater and greater risk-taking, leading to the trillions in losses now choking the financial system.

Financial panic

That all the bad lending precipitated a financial crisis by the summer of 2007 was not surprising, but that the crisis devolved into financial panic was shocking. A string of serious policy errors, beginning with the Treasury Department's decision to put Fannie Mae and Freddie Mac into conservatorship in early September 2008, precipitated the panic. The move wiped out shareholders and signaled to global investors that all financial institutions, no matter how large, were at risk of failure.

At the time they were seized, Fannie and Freddie may well have been technically insolvent if valuing their assets and liabilities at market prices. But they still had enough capital to satisfy government accounting rules. In past financial crises, policymakers gave large institutions in similar situations some latitude to avoid unnerving investors: Citigroup was likely insolvent during the early-1990s savings and loan crisis but was not seized by regulators. When Treasury Secretary Henry Paulson did not show the same forbearance to Fannie and Freddie, investors were spooked.

The markets' fears boiled over when policymakers allowed broker-dealer Lehman Brothers to fail one week later. Lehman's problem was not a lack of cash. It could use the credit facilities the Fed had established after the Bear Stearns collapse a few months earlier to stay afloat. But no other financial institution wanted to trade with a firm that might soon be out of business. Hedge funds that had used Lehman to execute their trades no longer did so, and bigger financial institutions forced Lehman to put up more collateral in case something went wrong. A year earlier, Lehman Brothers had been at the center of the financial system; now, over what seemed like just a few days, the system had shut Lehman out. The

company was careening toward bankruptcy.

The Treasury and the Federal Reserve worked feverishly to find a buyer for Lehman, as they had done for Bear Stearns, but no one stepped forward, leaving Lehman's fate to the Treasury and Fed. The Fed said Lehman lacked sufficient collateral to obtain a loan from the central bank. The Treasury said it could not bail out everyone and argued that the financial system had had plenty of time to prepare for Lehman's failure.

Yet, not everyone was prepared, and the failure to prevent a Lehman bankruptcy was a mistake. The Reserve Primary Fund, one of the nation's oldest and largest money market funds, had invested heavily in Lehman debt. The resulting loss caused Reserve to break the buck—the value of the fund's assets fell below what it owed its investors. This was a shock to many mom-and-pop investors who thought a money market fund was as safe as a mattress; they began withdrawing from the Reserve fund and others. Money market funds are typically large investors in commercial paper, the short-term IOUs of major businesses; now many funds had no choice but to freeze purchases or to sell commercial paper to meet their redemptions. Large firms began scrambling for ways to finance basic operations. Equity investors realized that no business was immune to the credit crunch, and stock prices plunged.

As the entire financial system neared the precipice, a rattled Secretary Paulson and Fed Chairman Ben Bernanke asked Congress to help them save the system. They asked lawmakers to put $700 billion into a Troubled Asset Relief Fund to buy the banking system's toxic assets. Neither the need for the $700 billion TARP nor how the money was to be used and overseen was well explained. Confusion grew over about how the asset purchases would be conducted and why they would quell the financial panic. With taxpayers incensed at being asked to bail out bankers and the election fast approaching, Congress failed to pass the TARP legislation on the first try. Financial markets boiled over in response, and Congress passed the TARP a few days later. However, the collective psyche had been badly damaged. There was no longer time to begin asset purchases, and the TARP money was used instead to infuse capital directly into teetering financial institutions. Taxpayers now owned big stakes in the nation's largest banks.

Although TARP funds were not being used for asset purchases, it was widely expected that they eventually would be. Investors were thus shocked when Secretary Paulson announced in November 2008 that the TARP would not be used for this purpose after all. Depressed asset prices fell even more; if the government was not going to buy these assets, no one would. The collateral damage from this decision was the near-collapse of Citigroup, which held hundreds of billions in bad loans and securities. Ironically, the only way to avert this calamity was for the Federal Reserve to guarantee Citi's troubled assets, the same assets the Treasury had decided not to buy.

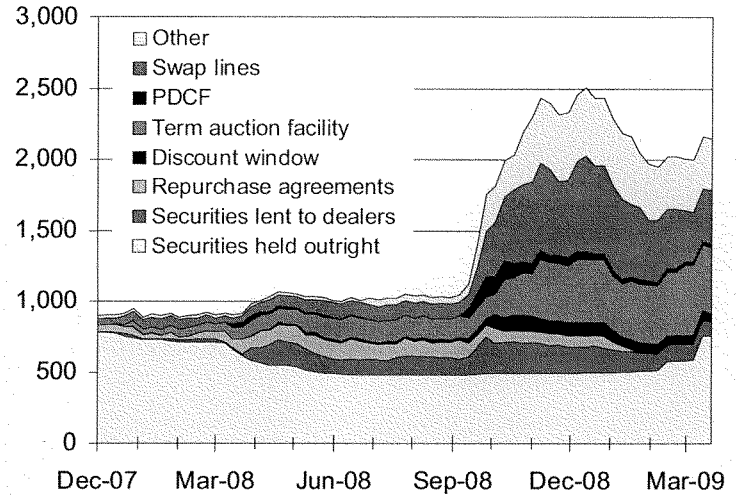
Thus, a string of policy errors had turned a severe yet manageable crisis into a nearly uncontrollable panic.

Buying, lending and guaranteeing

Policy mistakes precipitated last fall's financial panic, but generally adept policymaking ever since seems to have quelled it. Particularly noteworthy is the Federal Reserve's unprecedented use of its considerable resources to stabilize the financial system. Policymakers have slashed the federal funds rate to effectively zero and have indicated that the funds rate will stay there for an extended period.

The Fed has also engaged in credit easing, in which it essentially prints money to buy financial securities. The central bank is now buying commercial paper, debt and mortgage securities guaranteed by Fannie Mae and Freddie Mac, and Treasury securities. Before the financial crisis began, the Fed had approximately $1 trillion on its balance sheet, mostly in Treasury securities. It now has close to $2 trillion in a wide range of securities and has committed to increasing this to some $3 trillion by late this year (see Chart 2).

Chart 2: The Fed Prints Money
Federal Reserve's balance sheet, $ bil



Efforts to revive the commercial paper market have been particularly effective; the private market is now functioning well, and the Fed's commercial paper holdings have been winding down since peaking late last year. The decline in long-term Treasury yields and fixed mortgage rates is also evidence of the power of quantitative easing. With the Fed buying, 10-year Treasury yields are nearly 3.5%, and fixed mortgage rates have dropped close to 5% because of the lower Treasury yields and a narrowing in mortgage spreads.[ii]

The Fed has also dramatically expanded its lending to the financial system. Before the crisis, such lending was done only rarely and only through the Fed's discount window. A stigma was attached to banks that used the discount window, so most were reluctant to do so even if they needed the cash. To overcome this reluctance, the Fed established the Term Auction Facility in late 2007. The TAF allows banks to raise short-term cash through an auction, avoiding any stigma. To provide additional liquidity, the Fed also established the Primary Dealer Credit Facility and the Term Securities Lending Facility in early 2008.

The newest Fed lending facility is the Term Asset-Backed Securities Loan Facility, which this spring began providing attractive loans to private investors to purchase securities backed by a wide range of assets, including residential and commercial mortgages, credit cards, student loans, vehicle loans, and small business loans. The facility has gotten off to a slower start, with the Fed making only about $20 billion in TALF loans so far, primarily for purchases of credit card and auto loan securitizations. The Fed has said it is willing to make up to $1 trillion in such loans. The TALF's impact on the securities market is greater than these numbers would suggest, as interest rate spreads have narrowed meaningfully in anticipation of greater lending from the facility in the future. Ultimately, the TALF should be much more successful as the Fed adjusts it to make it attractive to more investors.

The Fed and FDIC have also worked to shore up confidence in the financial system by expanding various asset and deposit guarantees. The Fed now guarantees troubled assets at Bear Stearns, AIG, Bank of America, and Citigroup. Without this backstop, these institutions would have failed, likely creating a systemic catastrophe. The FDIC is also guaranteeing debt issued by banks. The Term Loan Guarantee

Program is backstopping well over $300 billion in bank debt. To forestall bank runs, the FDIC also increased deposit insurance from $100,000 to $250,000.

Shoring up balance sheets

Recent efforts by the Treasury Department have also helped quell the panic. The stress-testing of the largest bank holding companies this spring has been especially therapeutic. Tests were conducted on 19 banks, each holding more than $100 billion in assets and collectively accounting for two-thirds of total U.S. bank assets. The process provided a consistent framework for determining which institutions needed capital and how much. Institutions with capital holes have been required to fill them, which should eventually put them on a solid financial footing and thus reduce a major impediment to lending.

The stress tests determined expected loss rates for this year and next for different bank assets, including loans and securities. The banks were tested under a most-likely baseline economic outlook and also under a much more adverse outlook. The baseline was a bit more optimistic than the Moody's Economy.com baseline, particularly for expected unemployment, but the adverse outlook is reasonably dour, consistent with a Moody's Economy.com scenario that has a 20% probability of occurrence (see Table 4). That is, there is only a one-in-five chance that the economy performs meaningfully worse than this scenario. This is not quite what the Treasury and Fed advertised—they had argued that their adverse scenario had only a 10% probability of happening—but it is a very negative scenario nonetheless.

Table 4: Economic Scenarios Used in the Bank Stress Tests

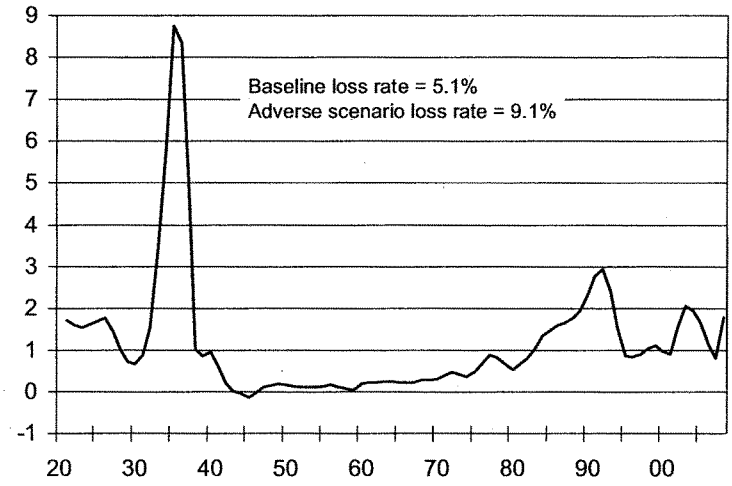
	2009	2010
Real GDP Growth		
CAP Baseline Scenario	-2.0	2.1
Moody's Economy.com Baseline	-3.0	1.4
CAP Adverse Scenario	-3.3	0.5
Moody's Economy.com 10% Scenario	-4.4	0.5
Unemployment Rate		
CAP Baseline Scenario	8.4	8.8
Moody's Economy.com Baseline	8.9	9.7
CAP Adverse Scenario	8.9	10.0
Moody's Economy.com 10% Scenario	9.6	11.0
House Prices (Case-Shiller® 10-city index)		
CAP Baseline Scenario	-14.0	-4.0
Moody's Economy.com Baseline	-19.4	-3.2
CAP Adverse Scenario	-22.0	-7.0
Moody's Economy.com 10% Scenario	-21.8	-9.3

Sources: Federal Reserve Board, Moody's Economy.com

Notes:
The stress tests are conducted under the Capital Assistance Program.
10% Scenario is designed so that there is a 10% probability that the actual economic outlook will be more severe.

Even more encouraging, the expected loss rates under both economic scenarios appear more negative than the underlying economic assumptions would imply. Assuming the baseline outlook, the total two-year loss rate across all assets is just over 5%, and assuming the adverse outlook, it is a very high 9%. The highest two-year loss rate ever was 9%, in the depths of the Great Depression (see Chart 3). Even during the savings and loan crisis of the early 1990s, the loss rate reached only 3%. Banks undergoing the stress tests will thus have enough capital to withstand an economic storm as bad as the Depression.

Chart 3: Bank Stress Tests Are Stressful
Commercial bank two-year loan loss rate



Of course, this is all in theory. If the economy were to experience a real depression, things might not go as scripted. Future earnings power is a key to how much capital each institution needs. The tests assume that institutions will remain profitable enough that after they raise more equity capital, sell off assets, and borrow from the government, their capital base will rise to a safe level. This assumption could be too optimistic if the economy seriously erodes.[iii] It is more likely that the economy will resemble the baseline, and these institutions will find themselves overcapitalized. Once they and their regulators feel certain this is the case, they can aggressively extend credit and acquire weaker or smaller financial institutions.

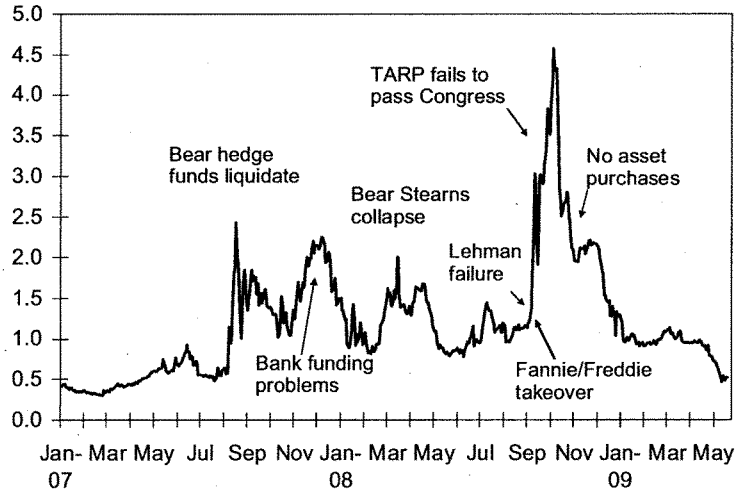
Stress-testing has had a noticeably positive effect on financial markets. Stock prices have rallied, even for the big banks that are issuing equity to meet the tests' requirements. There is no better endorsement of the process than the willingness of investors to pay more for shares in these banks after the tests than before. Yet more telling is the narrowing gap between three-month Libor and three-month T-bill yields—a good proxy for banks' willingness to lend to one another (see Chart 4). Big banks thus seem to believe that counterparty risk has been significantly diminished, if not eliminated.

With the financial panic receding, policymakers have significantly scaled back their plan for a Public-Private Investment Partnership. PPIP was supposed to provide banks with a mechanism for selling their troubled loans and securities to investors. Under the plan, the FDIC would provide cheap, low-risk financing to private investors for purchases of bad loans and securities from banks. By encouraging these asset sales, the government would reduce the uncertainty surrounding banks' viability stemming from the presence of these assets on their balance sheets. The program would also help restart markets for loans and securities, a necessity for a well-functioning financial system.

Under the PPIP's legacy securities program, a handful of very large investors would receive FDIC loans to purchase securities from banks. Although investors would be required to put up some of their own money, the FDIC would finance most of the purchase, magnifying potential returns. The FDIC loans would be nonrecourse; thus, investors would risk only whatever they themselves put up. The legacy security

program is not much different from the TALF, but it targets existing securities and, unlike the TALF, includes securities rated lower than Aaa. The other PPIP program, the legacy loan program, is more novel, in that it would let banks auction existing loans to a broad array of private investors, who would receive cheap FDIC financing. The legacy security program appears set to begin soon, but the legacy loan program has been mothballed given banks' reluctance to participate in the auctions and a number of other impediments.

Chart 4: Financial System Is Stabilizing
Difference between 3-month Libor and Treasury bill yields



Not following through on PPIP or other efforts to get troubled loans off bank balance sheets may eventually prove to be a mistake if credit conditions continue to weaken and the capital raised in response to the stress tests is ultimately insufficient. However, given that credit conditions appear to be improving, this is a gamble policymakers seem willing to take.[iv]

Exit strategy

The unprecedented policy response to the financial panic was necessary and appropriate, but it will not be easy for the government to extricate itself gracefully from its massive intrusion into the financial system. The Federal Reserve has interests in assets amounting to trillions of dollars, and taxpayers now either own or hold sizable stakes in many of the nation's largest financial institutions. There is reasonable concern that this could lead to runaway inflation and that government's heavy hand could disrupt the day-to-day activities of financial institutions. The financial system will not provide credit efficiently, in the manner necessary for sturdy, long-term economic growth, until the government significantly withdraws.

Worry that the Fed's actions will ignite runaway inflation is not misplaced. Inflation is after all a monetary phenomenon, and the Fed is printing trillions of new dollars. But although inflation may well become uncomfortably high early next decade, it is unlikely to be as bad as feared and is certainly not a reason for the Fed to restrain its response to the current crisis. Money ignites inflation only if it first leads to more and cheaper credit, which then fuels economic activity enough to tighten labor markets and push

utilization rates near capacity. Policymakers will have time to act before this happens; it could be years before credit flows freely again and the economy finds its way back to full employment.

It is also worth noting that most of the Fed's new liquidity is in the form of short-term credit, maturing in less than 90 days. Once policymakers feel comfortable that the financial system and economy have stabilized, these programs can fade away. The Fed is providing liquidity with longer maturities—an example would be five-year TALF loans to facilitate investor purchases of commercial mortgage securities—but it is also working on new mechanisms such as issuing its own debt to drain longer-term liquidity when this is needed.

Firmly ingrained at the Federal Reserve is the belief that low and stable inflation is the central bank's first priority; sturdy, long-term economic growth is not possible without it. The Fed would almost surely raise interest rates aggressively, sacrificing near-term growth, to ensure that inflation does not rise too far above its target for too long.

Getting the government out of the financial services business could take much of the next decade. In fact, the government's stake in the system may expand further in the next several years as it places hundreds of smaller institutions in receivership. Of the 8,400 depository institutions now operating—including commercial banks, savings and loans, and community banks—nearly 1,000 are at significant risk of failing. Many will choke on bad commercial loans that will overwhelm their capital base.

It is encouraging that a number of the banks that took TARP money have begun to repay it. They have quickly realized that having the government as an owner entails considerable cost. Compensation practices have come under intense scrutiny, and the focus could easily turn to other business practices such as underwriting standards or resolving problem loans. It is not hard to envisage political pressure being brought to bear on government-aided financial institutions to ease lending or repayment terms. Once policymakers issue guidelines to banks seeking to repay TARP money, many institutions will quickly do so.

It will take much longer for the government to divest its ownership of behemoth institutions Fannie Mae, Freddie Mac and AIG. Fannie and Freddie play a central role in the housing market; privatizing them would mean higher mortgage costs and less credit. Selling AIG will be difficult, given the complexity of its operations. Thus, these institutions will likely be sold off in stages, as pieces are carved out and taken public or sold to private investors. It will be a daunting process, but it could go better than expected if, when financial conditions improve, these companies are sold at high enough prices to make a difference in correcting the federal government's severe fiscal problems.

Regulatory reform

As the Great Depression dramatically transformed the nation's financial system, so, too, will this crisis. From the ashes of the Depression rose the FDIC, Fannie Mae, and the Federal Home Loan Bank system; investment and commercial banking operations were separated; and the SEC was established. From the ashes of this panic, the nation's regulatory structure will be reworked and the financial system transformed. The goal will be to reduce the odds of future financial crises and the economic fallout should they recur.

A beneficial result of the financial crisis is an opportunity to rework the regulatory framework overseeing the financial system. The Obama administration's proposed regulatory reform is much-needed and reasonably well-designed. The financial panic has been quelled, but the financial system remains in significant disrepair. Credit remains severely impaired, as the growth in household and nonfinancial corporate debt weakened to its slowest pace on record in the first quarter of this year. The economy will not regain its footing until credit flows more freely. Reform is necessary to restore confidence in the financial system, particularly among global investors, and thus to revive it. The reform proposal is well thought out, at least in theory, as it attempts to fill most of the cracks in the regulatory framework that contributed significantly to the crisis.

An attractive aspect of the reform plan is that it establishes the Federal Reserve as a systemic risk regulator with the authority to adjust the capital and liquidity levels and risk management practices of all financial institutions deemed to pose a potential threat to the stability of the financial system. This would include all institutions, from the commercial banks it has historically overseen to those that it has not such as hedge funds and insurance companies. The Fed is uniquely suited for this task given its central position in the global financial network, its significant financial and intellectual resources, and its history of political independence.

As a systemic risk regulator, the Fed would be able to address an age-old problem: Namely, that banking regulation tends to be procyclical. When credit quality is good and lenders are aggressive, regulators have difficulty imposing discipline; when quality is poor and lending is tightening, the disciplinary screws are tightened. This procyclicality tends to exacerbate swings in lending standards and credit availability. It partly stems from regulators' inability to respond quickly, but it also reflects the influence of politics. Lenders find it much easier to keep regulators at bay when credit conditions appear robust, although those periods are generally when increased oversight would be most beneficial.

The Fed's new role would also come with an implicit mandate and meaningful tools to counteract asset bubbles. A long-held view at the Fed is that battling bubbles is not its job: Bubbles are difficult to identify, raising interest rates is a blunt way of attacking them, and if a bubble does burst, then lower interest rates are an effective response to the economic fallout. But as the nation's systemic regulator, it would be difficult for the Fed to ignore potential bubbles. As is clear now, ignoring them poses a mortal threat to the financial system. And as the systemic regulator, the Fed would presumably be able to significantly influence the amount of leverage, an essential ingredient in any asset bubble.

Responding to potential bubbles will not be easy, but little of what the Fed does is. Bubbles are always born out of something fundamental—the internet's debut for stocks, low interest rates for housing, or Chinese demand for oil—making them difficult to recognize at the time. Yet, the central bank is often asked to make judgments of equal, if not greater, difficulty. Will record oil prices undermine inflation expectations and result in higher underlying core inflation? Are a zero funds rate target and the purchase of Treasury bonds appropriate responses to the financial crisis? Was putting the Fed's balance sheet on the line to resolve the Bear Stearns collapse and save Citigroup and AIG beyond the Fed's mandate? Deciding whether a bubble exists in housing is no more difficult than these questions. A Federal Reserve that determines the nation's monetary policy and is also its chief financial regulator could reduce the odds of future financial crises through the deft use of all its tools, but it must also demonstrate the courage of its convictions.

The reform would also establish a Consumer Financial Protection Agency with the authority to protect consumers of financial products including credit, savings and payment services, and to regulate the institutions providing these products. This is a good idea, as it is clear from the current crisis that consumers' understanding of their obligations as borrowers or the risks they take as investors is limited. It is also clear that under the current regulatory framework, the authority to protect consumers is too widely dispersed across various regulatory authorities such as the Federal Reserve, SEC and FTC and not well coordinated and enforced.

The idea of a new consumer protection agency has come under much criticism from financial institutions that fear it would stifle their ability to create new financial products and would raise the cost of providing existing ones. The new agency would not always strike the right balance between consumer protection and overprotection, but it would help ensure that consumers understand what they are paying for. The Federal Reserve also seems reluctant to let go of its regulatory authority in this area. But the Fed has historically given its oversight of consumer financial products short-shrift compared with its weightier responsibilities, which would get even weightier with this proposed reform. Under laws passed as long ago as the mid-1990s, the Fed has had the authority to issue guidance to all mortgage lenders, regardless of their charter and regulator, regarding what constitutes appropriate lending.[v] The Fed did not exercise that authority until well after the current foreclosure crisis was under way.

The proposal also addresses a key failing exposed by the current crisis—what to do about financial

institutions whose failure would put the entire financial system at risk. The proposed reform would help avert cases like Lehman Brothers, whose failure brought the financial system to the edge of collapse last fall. The Treasury and Fed were seemingly confused as to whether they had the authority and ability to intervene to forestall a Lehman bankruptcy and ensure an orderly resolution of the broker-dealer's failure. With the proposed reform, there would be no such confusion in the future.

Among a number of other proposed reforms that would help prevent crises, originators of securitized assets would be required to retain a material economic interest in a security's credit risk. Without so-called skin in the game, issuers did not have adequate incentives to make sure the underlying loans in their securities were appropriately underwritten. The proposal also regulates over-the-counter markets for derivatives, including the credit default swap market to increase transparency and efficiency in these markets. Their opacity contributed to the uncertainty and thus the panic that pervaded the financial system in the crisis. And the proposal calls for increased oversight of hedge funds, money market mutual funds, and insurance companies. The proposed oversight appears modest, including registration of hedge funds, studying the structure on money funds, and collecting more information on insurance companies. Since all of these institutions played some role in the crisis, it is important for regulators to know more about them.

The most significant criticism of the Obama reform proposal is that it does not rationalize the current byzantine regulatory structure. An alphabet soup of federal and state regulators has watched over the financial system since the Great Depression, each regulatory body with its own narrowly defined jurisdiction. The OCC is responsible for bank holding companies, the OTS for savings and loans, the FHFA for Fannie Mae and Freddie Mac, and so on. During the housing bubble, the lenders that made the worst loans were able to skirt regulation by establishing corporate structures that fell outside any regulator's watch. Some of the most egregious loans were made by REITs that were all but ignored by the SEC, their nominal regulator.

The proposed reform also fails to adequately identify the lines of authority among regulators and the mechanisms for resolving differences. A new Financial Services Oversight Council would bring the key regulators together, but such a system would differ little from current interagency meetings. Regulators' inability to agree on guidance for financial institutions' lending practices contributed significantly to the current crisis. Basic guidance on alt-A mortgage lending was not forthcoming until late 2006, and subprime guidance waited until mid-2007, well into the crisis, as regulators could not agree on the exact wording.

Under the reform proposal, the thrift charter would be eliminated, and its regulator, the Office of Thrift Supervision, subsumed into the FDIC. The proposal also broadens the definition of a bank holding company to include thrifts, industrial loan corporations, credit card banks, trusts, and other grandfathered nonbanks. This broader definition would allow for more consistent regulation across this plethora of institutions. But although regulatory arbitrage would be a bit more difficult under these changes, it would remain a significant problem.

It is also worrisome that the Federal Reserve's political independence would be at greater risk under the reform proposal, given its significantly larger role in regulating the financial system. Its independence is vital to the appropriate conduct of monetary policy. The proposal provides no new mechanisms to ensure the Fed's independence. In fact, the Fed would be required to secure the Treasury Department's agreement to take action on the "exigent circumstances" clause of its charter.

The proposed regulatory regime would not have forestalled the current crisis, but it would have likely made it less severe. Even the best regulatory structure and oversight would have been unable to stop the flood of global investor dollars that fueled trillions of dollars in poorly underwritten lending at the root of the crisis. Booming emerging economies from China to Russia had a surplus of dollars earned in their lopsided trade with the U.S. Nothing in the proposal addresses this broad global macroeconomic imbalance.

The proposal does address other key imbalances, including the dysfunctional securitization process. The bad lending that took place leading up to the crisis was due in part to the fact that no one in the securitization process had enough at stake to make sure the loans were being made to creditworthy borrowers. The reform would require issuers of these securities to hold onto some of the credit risk inherent

in them. The risks taken in the credit default swap market would likely also have been less substantial than under the current regulatory regime. The failure of insurer AIG was due in large part to that institution's egregious risk-taking in the CDS market. With the greater disclosure required under the proposed reform, it would have been more difficult for AIG to be such a large player in that market.

Households might not have borrowed as aggressively during the housing boom if they had fully understood the mortgage loans they were taking on. Subprime, alt-A, and option ARM mortgage loans became increasingly complex as the housing market boomed. Fed surveys show that a sizable proportion of subprime mortgage borrowers did not understand that their payments probably would increase substantially in as soon as two years of receiving the loan. Had a consumer protection agency such as the proposed one been in place, it would have been much more difficult for lenders to extend such loans.

Similarly, had the Federal Reserve been the nation's systemic risk regulator, it might have reduced leverage in the entire financial system, particularly with respect to Fannie Mae and Freddie Mac, as the Fed had already publicly expressed its skepticism over their significant risk-taking. However, the Fed would not likely have been willing to require broker-dealers to raise more capital and reduce leverage, as regulators were actually allowing many of these institutions to take on more leverage, given their perceived acumen in managing risk. There was also little appetite to require more disclosure and less risk-taking by hedge funds.

Perhaps most importantly, the proposed regulatory regime would have allowed for a more orderly resolution of troubled institutions such as the GSEs, Bear Stearns, Lehman Brothers and AIG, which fell outside the purview of the Fed and other banking regulators but would be subject to oversight under the proposed system. It was the botched resolution of these institutions, partly because regulators lacked clear authority, that turned the financial crisis into a financial panic last fall.

Future financial system

The financial crisis is dramatically transforming the financial system. The traditional banking system will increasingly be dominated by either very large institutions or by small ones. Securitization—the bundling of loans into securities purchased by global investors that fueled the shadow banking system—will be resurrected but redesigned so that all parties have sizable stakes in ensuring the process works properly.[vi] Over-the-counter trading will be largely replaced by more centralized trading so regulators can oversee the derivatives markets that contributed to the crisis.

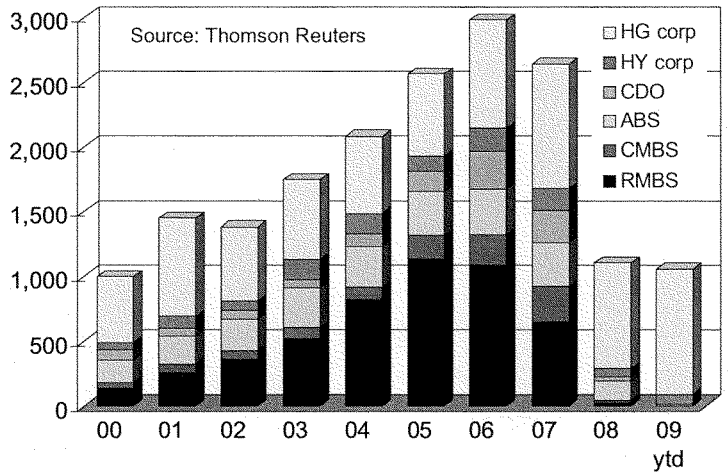
The crisis has shown that too many financial institutions are too big to fail. That is, their failure could undermine the system, leaving policymakers with little choice but to intervene. The desire to break up these institutions is understandable but ultimately futile. There is no going back to the era of Glass-Steagall; breaking up the banking 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.[vii] Large Canadian and Australian banks that weathered the current crisis well, for example, are making rapid inroads into U.S. banking markets. Banking institutions from China and other emerging economies are not far behind.

Large financial institutions are also needed to finance and backstop the shadow banking system and financial markets. Large banks provide much of the short-term cash that makes securitization run. It is more efficient and practical for regulators to watch over these large institutions and, by extension, the rest of the system. That is roughly how things were supposed to work before the current crisis, but the oversight was poor. With the Fed as the systemic risk regulator and a quicker mechanism for resolving the troubles of even large, complex institutions, oversight should measurably improve. These large institutions should also be required to hold more capital, satisfy stiffer liquidity requirements, be subject to greater disclosure requirements, and pay deposit and perhaps other insurance premiums commensurate with the risks they take and pose to the entire financial system.

While large institutions will dominate the financial landscape, there will be plenty of room for smaller players that cater to the needs of America's Main Street businesses. Small-business loans offer few economies of scale and require close knowledge of the business and its owner. Small-business owners also prefer working with smaller banks, which are more likely to work with them when times get tough.

The future financial system will also have an important role for securitization. It is true that the process that thrived during the last two decades—in which lenders made and quickly sold loans to investment bankers, who packaged them into rated securities to be resold to global investors—has collapsed. No one involved had enough at stake if a loan went bad, so many bad loans were made. Some $3 trillion in nongovernment-related securities was issued at the peak in 2006, compared with only about $1 trillion (annualized) so far this year (see Chart 5). Not a single residential or commercial mortgage security has been issued, and very few credit card, auto, or other asset-backed securities have appeared since late 2008.

Chart 5: Securitization Remains Troubled
Bond issuance, $ bil, annualized



Securitization will be resurrected, but it will be much simpler, and everyone involved will have a stake in making sure the underlying loan is good. Despite its clear vulnerabilities, the economics of securitization remain compelling. The fundamental logic underlying the process is sound: It unbundles the risks in lending and matches them with the risk tolerance of investors. More investors can thus participate, allowing more credit to flow to households and firms throughout the global economy. Securitization should and can be fixed.

The Fed's TALF program, in which investors receive cheap, low-risk loans to purchase the top-rated parts of securitizations, is a first crack at fixing the process. Participating lenders—auto finance and credit card companies, for example—hold the riskier parts of the securitization. If they make too many bad loans, they will suffer. Another idea gaining traction is the covered bond. It is a securitization, but loans backing the security remain on the lender's balance sheet. If loans go bad, the lender is responsible for replacing them. If many loans backing the security go delinquent and investors in the security stop receiving their money, they can go after the lender's other assets. Lenders thus have a strong incentive to make sure loans are properly underwritten. Yet, both regulatory and taxpayer help might be needed for the covered bond idea to really get going.

It would be a mistake to scrap securitization altogether and go back to the simple originate-to-hold

model of the past. Credit would be much less ample and more costly, even for creditworthy borrowers. There is, moreover, no guarantee that scrapping securitization would prevent missteps. The savings and loan crisis of the early 1990s was caused by the most plain-vanilla of lending institutions.

Centralized exchange trading of derivatives will grow to replace over-the-counter trading in the future financial system. OTC trading now occurs for many securities, including many derivatives at the center of the crisis. Perhaps most problematic is the market for credit default swaps, insurance contracts on fixed-income securities such as corporate and mortgage-backed bonds. AIG was particularly active in the CDS market, where it lost tens of billions of dollars that taxpayers have since been paying out. CDS in theory should mitigate risk in the financial system by allowing investors to hedge risks. In practice, they engendered uncertainty and fear. Because CDS are not traded on an exchange, there was little information regarding who bore what risks. This contributed to the freezing up of the financial system.

Although OTC trading has its place, particularly in commodity markets, regulators are pushing to move trading to organized exchanges. Such a move would increase transparency and accountability, both essential ingredients to averting future financial crises and mitigating the fallout if they occur.

Conclusions

The financial crisis is two years old and counting. It began as more than a garden-variety crisis, when the system choked on trillions in bad mortgage loans, but it did not devolve into a panic until a string of serious policy missteps in the fall of 2008. Placing Fannie Mae and Freddie Mac in conservatorship and allowing Lehman Brothers to go bankrupt were too much for the system to bear. Some good policy decisions since then, including the stress tests of the nation's largest bank holding companies, seem to have quelled the panic by the spring of 2009. Assuming that other efforts to shore up the system and end the recession succeed, the crisis should be over by this time next year.

The fallout will continue much longer, however. This has been a psychologically scarring period, and anyone involved will not forget it. Credit will slowly resume flowing more normally but will not flow as freely or as cheaply until a new generation with no memory of this period takes the reins of the financial system. Credit is the mother's milk of an economy; it drives the innovation and technological change so vital to long-term productivity growth. More cautious capital means slower long-term growth.

But the financial crisis is also generating the political will necessary to make long-overdue changes to the regulatory framework and to the financial system itself. The current regulatory structure was built during the Great Depression and feels like it. Financial institutions now provide a blizzard of products and services across the globe, and yesterday's rules are no longer up to the task. The financial system's plumbing is also getting a good overhaul. The fundamental processes of securitization and trading will be revamped to make them more transparent and institutions more accountable. After this crisis, the financial system will not be as flashy or as fast-moving as it was, but it will be more stable and sure.

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[i] The savings and loan crisis of the early 1990s ultimately cost taxpayers an estimated $250 billion in today's dollars, equal to less than 3% of GDP at that time. See "The Costs of the Savings and Loan Crisis: Truth and Consequences," FDIC, 2000. www.**fdic**.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf

[ii] Long-term Treasury bond yields and mortgage rates have moved up substantially since early May. This rise reflects investors' views that the economy's prospects are improving, which is consistent with the rise in equity prices over the same period. It also reflects worries about a surge in Treasury bond issuance to finance the government's response to the current crisis, which is evident in the increase in CDS spreads on Treasury bonds. Pressure is rising on the Fed to increase its Treasury purchases beyond the $300 billion committed so far.

[iii] It is encouraging that the Federal Reserve appears to be limiting what share of the banks' additional capital requirements can be satisfied by expected future earnings.

[iv] Although it is creative and has a reasonable chance of success, the PPIP will ultimately cost taxpayers

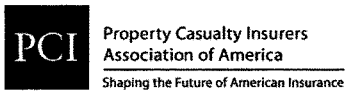
much more than if the government had purchased the bad assets directly. The government is giving up much of the future return on these assets to private investors, even though it is taking much of the upfront risk. Concern that the government itself might overpay for the assets seems overdone; the government would use roughly the same models as investors would to value assets. However, direct government asset purchases would require more upfront taxpayer money than is now available in the TARP. The administration would thus have to go back to Congress for more money, something it clearly feels it cannot do.

[v] The Home Ownership Equal Opportunity Act passed in 1994 gave the Federal Reserve this authority.

[vi] The shadow banking system includes all nondepository institutions, ranging from hedge and sovereign wealth funds to pension and mutual funds.

[vii] The Glass-Steagall Act of 1933, among other things, established the FDIC and prohibited banking holding companies from owning other financial companies. The thinking was that institutions that combined commercial and investment banking were too speculative and created a less stable financial system. The Gramm-Leach-Bliley Act passed at the end of 1999 repealed this prohibition, resulting in the formation of very large financial institutions, many of which have failed or have required significant government help to avoid failure in the current crisis.

www.pciaa.net/reg-reform



Testimony
Property Casualty Insurers Association of America (PCI)
Committee on Financial Services
United States House of Representatives
Tuesday, July 21, 2009

Chairman Frank, Ranking Member Bachus, and members of the Committee, thank you for the opportunity to present testimony today on the question of whether some financial services companies are "too big to fail." The Property Casualty Insurers Association of America is the leading property-casualty trade association representing more than 1,000 insurers, the broadest cross-section of insurers of any national trade association. Our testimony supports your call for a systemic risk regulator to address vulnerabilities in our financial marketplace, requests that this effort be done carefully with bright-line objective tests that distinguish activities that are not generally systemically risky, and suggests a detailed framework for measuring and overseeing systemic risk, building off proposals in the Administration's recently released Financial Regulatory Reform paper.

The financial crisis that began last year has brought into sharp focus a key vulnerability in our current financial services regulatory system -- the absence of a comprehensive understanding of the nature of systemic risk and effective systemic risk oversight. The Federal Reserve Board currently has "umbrella" systemic risk authority only over financial holding companies. To date, this regulation has been bank-centric and has not focused on careful monitoring and understanding of the risks posed by non-bank entities within the financial holding company structure. In fact, former Federal Reserve Chairman Alan Greenspan has admitted that the Board's regulatory focus failed to effectively monitor and regulate the systemic risk to the larger economy. Furthermore, the Board does not have systemic risk regulatory authority over major thrifts or thrift holding companies (e.g., Indymac, Countrywide, Washington Mutual), investment bank holding companies (e.g., Lehman Brothers, Bear Stearns) or highly leveraged derivatives underwriters. Existing prudential regulators who do have jurisdiction over those entities have not focused on systemic risk. Even within the banking system, the Federal Reserve Board and other depository institution regulators did not regularly collect or coordinate the necessary marketplace information to adequately identify and limit systemic risk.

It is vital that these regulatory gaps be filled now. Irrational exuberance in the marketplace is inevitable and innovative risk-taking should not be restricted. But regulators should be given the tools to monitor systemic risk and a government entity tasked with a primary responsibility of trying to identify and limit the impact of the next bubble burst. It is equally vital that Congress establish bright-line systemic risk measurements based on a solid understanding of what systemic risk is and which activities within our financial system do and do not pose systemic risk. This will help restore marketplace confidence and reduce moral hazards.

The Administration's Proposal on Financial Regulatory Reform

The Administration's Financial Regulatory Reform paper proposes a good starting point for addressing systemic risk. It designates a single entity responsible for monitoring systemic risk, with jurisdiction broad enough to fill existing umbrella supervision oversight gaps. The paper recognizes that systemic risk can come from non-bank activities, and requires the systemic risk regulator to work with existing primary functional regulators in collecting information and making regulatory determinations. It recognizes that there are several factors, including leveraging and interconnectedness, that can contribute to systemic risk. The paper also proposes some useful oversight requirements for companies conducting systemically risky activities.

PCI's testimony today suggests a number of refinements to the Administration's systemic risk proposals for consideration by Congress. We appreciate that the Administration has explicitly recognized that "the current crisis did not stem from widespread problems in the insurance industry" and understands that property-casualty insurance is not generally systemically risky. However, a number of the proposed tests if measured in isolation could be over-inclusive and could create significant unintended negative economic consequences if not properly structured. For example, size alone ("too big") does not make a company systemically risky, particularly where its activities have a very low likelihood of failure, where such failure is unlikely to be correlated with systemic downturns, or where the failure would have minimal impact on critical financial markets such as the credit and capital liquidity markets.

Measuring Systemic Risk – Initial Screening

The most important first step in categorizing companies for systemic risk is to create a relatively simple screen to weed out the vast majority of companies that are unlikely to present significant systemic risk. It is critical that systemic risk analysis be executed based on individual activities, not on a consolidated whole. Some financial activities are simply not systemically risky and should not be subjected to further reporting burdens or oversight creating additional costs for consumers. The initial screening should measure activities that are generally interconnected and correlated with systemic downturns, to determine the amount of off-balance sheet leveraging of liabilities or uncollateralized liabilities for which regulatory capital is not required (including structured collateralized liabilities for which the collateral cannot practically be identified). This framework builds on the suggested tests in the Administration's proposal to focus on leveraging (including off-balance sheet exposures), interconnectedness – "a firm's criticality as a source of credit or liquidity", and the negative economic impact of a firm's failure.

3 Part Weighted Measurement for Systemic Risk:
"Too Risky, Cyclical, and Interconnected for a Disorderly Failure"

For those companies which are conducting significant amounts of potentially systemically risky activities, PCI suggests that Congress consider a weighting of the three elemental systemic risk components for each basket of activities a firm conducts, similar to a combination of the Administration's proposed tests. These are:

- Failure probability (the historic failure rate of the activity modified by the company's leveraging and transparency);
- Cyclicality (the correlation of the activities with systemic downturns), and
- Potential economic impact (interconnectedness/negative economic impact on credit and liquidity).

It is critical that this more sophisticated systemic risk analysis be a weighting rather than a series of binary size-base tests. For example, a company's activities can be highly leveraged and at-risk of failure, but without cyclicality (no correlation with downturns – such as funeral insurance) or with minimal interconnectedness (such as insuring professional athletes) such that any impairment would not significantly affect a critical credit or liquidity market. An activity could be cyclical (correlated with downturns), but with negligible likelihood of failure (liabilities are regulated, well capitalized or capitalized, and with minimal leveraging) or unlikely to negatively impact credit or liquidity markets because the operations are relatively small or unrelated to critical credit or liquidity markets (such as a recreational boat insurer). Finally, even some financial operations whose failure could negatively impact critical interconnected markets are not systemically risky if the activities have negligible likelihood of failure (fully regulated, capitalized, and unleveraged), are countercyclical risks (such as hedges that benefit the company during downturns and only create liabilities during periods of economic growth), or have failure costs covered by state guaranty funds (thus eliminating or minimizing 3rd party failure exposure). It is only the combination of these three factors (failure-risk, cyclicality, and interconnectedness) that creates systemic risk, not any of these factors in isolation based on absolute size. The vulnerability is not really "Too Big to Fail", but rather companies whose activities are "too risky, cyclical, and interconnected for a disorderly failure."

Additional Systemic Risk Measurement Concerns

To lessen moral hazard and increase regulatory flexibility, Congress should also consider avoiding binary systemic risk classification. A scalable systemic risk oversight system can allow a graduated increase in regulatory standards while avoiding a one-size-fits-all set of reporting, capital standards, supervision and risk management. A more robust and formalized regulator information sharing system would help the systemic risk regulator monitor market trends and company risk. However, forced conversion of small non-bank financing companies that are a negligible part of larger conglomerates into banks and their holding companies into bank holding companies would not lessen systemic risk – the simple fact of affiliation with a relatively very small bank-equivalent does not by itself create additional systemic risk. Numerous insurers have small thrifts that provide important consumer services but do not create systemic risk to the holding company.

Systemic risk measurements for new financial products will need to be flexible. However, for existing financial products, the market will benefit from objective, bright-line tests so that companies can avoid activities that would be considered significantly systemically risky and moral hazards can be minimized. In addition to excluding (or near-zero weighting) of non-systemically risky activities from aggregate systemic risk measurements, risk measurements should distinguish between liabilities that affect the entire holding company versus exposures limited to particular affiliates or affiliate groups. The transparency (public disclosure) and regulatory oversight of an activity should be also factored into systemic risk weightings, as should systemic risk history. For example, large thrifts have evidenced an extremely high cyclicality – boom and bust cycle – for many decades that is highly correlated with economic downturns. Similarly, highly leveraged off-balance sheet derivative activities were a major cause of the 1998 global financial crisis and the collapse of Long Term Capital Management (LTCM). We know these activities cause significant systemic risk, and should target oversight accordingly.

Summary of Attachments

PCI appreciates the initial Administration proposal and Congressional framing, and we look forward to answering any questions and helping members of the Committee further refine and define a clear systemic risk oversight structure. PCI's detailed proposals are attached with respect to:

- Systemic risk principles
- Systemic risk measurement
- Systemic risk oversight
- Resolution of systemically risky companies

Also attached is a table and graphic showing the impairment rates for four major financial sectors over the last 30 years, including during the past four systemic downturns.

Analyzing, Measuring, Overseeing and Resolving Systemic Risk

"Systemic risk" is the likelihood and the degree that the institution's activities will negatively affect the larger economy as part of a systemic downturn such that unusual and extreme federal intervention would be required to ameliorate the effects.

Principles of Systemic Risk Measurement

- Initial systemic risk screening should focus on unregulated activities and factors such as the degree of leverage and uncollateralized liabilities (for which regulatory capital is not required), off-balance sheet exposures (which include those liabilities which have been accounted for as a sale -- and thus removed from the financial statements -- but where the company has not surrendered control over those liabilities), and degree of reliance on short term funding.
- Subsequent systemic risk measurements should not be binary (fail/pass) tests, but should be weighted to take account of varying degrees of risk. Key elements of an effective system risk system should include:
    - Weighted risk tests based on failure probability and correlation with and contribution to overall systemic risk;
    - Scalable systemic risk oversight;
    - Systemic risk measurements that provide a break-down by industry group, identifying and allowing for exclusion of non-risky activities and corporate structure that segregates liability (e.g., if an insurer is engaging in a derivatives business through a subsidiary, only the derivatives subsidiary should be designated as systemically risky); and,
    - Focus on monitoring and regulation of systemically risky activities to minimize systemic economic downturns rather than on punitive measures.
- Different activities engaged in within a group or company should be analyzed separately so that activities that are not systemically risky (e.g., property-casualty insurance) will be excluded from aggregations. Activities should also be excluded to the extent that any liabilities arising from those activities are already covered under risk-based assessment or guaranty fund systems. Systemic risk measurements should be objective bright line tests, with well defined terms.
- Companies in regulated industries with guaranty funds should not be subject to the same strict capital requirements or required to subsidize resolution costs of less regulated activities without guaranty funds – this would create an enormous moral hazard.
- Very small affiliated thrifts or similar entities that are forced to convert into banks that do not themselves pose systemic risk should not subject their holding companies to stricter bank holding company regulation and required divestiture of non-financial (commercial) activities within 5 years. This is overly prescriptive and not appropriate in all circumstances, especially where the affiliated thrift is small and poses negligible systemic risk.

Measuring Systemic Risk

Step 1 – Screen to Eliminate Systemically Non-Risky Entities

For prudentially regulated entities, initial systemic risk screening should be performed by the functional regulator, focusing on unregulated activities and factors such as the degree of leverage and liabilities without specific collateralization (for which regulatory capital is not required), off-balance sheet exposures, and degree of reliance on short term funding.

Step 2 – Measuring Degree of Systemic Risk to Determine Appropriate Regulatory Response

Systemic risk is a company's probable contribution to a systemic downturn. It is a weighted multiple of three factors calculated separately for each group of activities:

- Failure probability;
- Cyclicality; and
- Economic impact.

Failure Probability. The likelihood of failure is the probability of insolvency of the relevant financial activity of a company, which for existing product lines can be measured historically. For example historical impairment rates for insurance and banking are: 0.29% for property casualty insurance; 0.32% for life insurance; 0.65% for banking; 3.19% for thrifts.[1] This historical failure measurement by activity would then be adjusted up or down for each company based on bright-line predetermined formulas depending on whether the following factors are above or below average for the activity:

- Capital reserves;
- Leveraging;
- Liquidity;
- Reliance on short-term funding
- Enterprise risk management; and
- Transparency (regulatory and public disclosure).

Cyclicality. The "cyclicality of risk" is the degree to which impairments correlate with economic downturns. For example, the correlation coefficient for p/c over the past 30 years is extremely low, as economic downturns do not correlate with increased auto or homeowners accidents, p/c markets are somewhat inelastic (mandatory), and p/c insurers are not subject to a "run on the bank". In contrast, activities that have exhibited higher cyclicality of risk include mortgage lending, credit lending, and derivatives.

Economic Impact. Economic impact is the expected contraction a firm's failure would cause to critical financial markets (such as the credit and capital liquidity markets) and the resulting reduction in U.S. gross domestic product (GDP). A very blunt cursory measure of potential economic impact is the amount of highly leveraged liabilities that are not already addressed by a government or statutory-enacted guaranty fund mechanism. A more sophisticated analysis would examine the potential reduction of supply in critical financial markets (credit and capital) that the failure of a firm's activities would cause, potentially measured by the price increases in those critical

[1] See attached chart, "Impairment Experience of the Financial Services Industry, PCI, 2009.

markets during a systemic crisis (such as the increase in LIBOR rates, nonconforming mortgages, equity and debt issuances, and auction rate securities failures and prices). A very high level analysis might also consider the effect of a firm's failure on counterparty industries, measuring off-balance sheet liabilities owed to other major systemically risky firms.

New Financial Products. More subjectivity would have to be allowed to assess the systemic risk of new financial products that do not have historical failure or cyclicality data, considering factors such as: the extent to which the product is regulated, the extent to which the providers underwrite their own risk, whether the risk accrues to the provider or investors, the ability and likelihood of a consumer run, the level of allowed leveraging and required collateral, elasticity of demand, and the extent to which the individuals making risk decisions are compensated based on short term returns.

Systemic Risk Oversight Framework

Issue	Proposal
COVERED COMPANIES	Only systemically risky US financial companies. The focus should be on those activities of holding companies and financial subsidiaries that are not subject to prudential regulation by a functional regulator, targeting financial entities with large off-balance sheet exposures and other obligations that are indicative of systemic risk.
SYSTEMIC RISK DEFINITION	Systemic risk is the likelihood and the degree that a financial institution's activities will negatively affect the larger economy as part of a systemic downturn. It can be measured by a risk weighting of the likelihood of failure, cyclicality of risk, and economic impact of firm's activities. Respectively, these factors would be based in part on historical failure rate of a product line (adjusted by available capital, leveraging, liquidity, reliance on short-term funding, etc.), the historical proclivity of a product line to fail in unison with economic downturns, and the estimated supply contractions caused by such product lines to various critical financial markets during systemic failures (measured by price spikes after failures). Heavily regulated activities with low leveraging, low interconnectedness, and high transparency are generally not systemically risky, and systemic risk is further reduced to the extent that obligations are already covered by existing industry guaranty funds.
TRIGGER	Systemic risk (SR) regulation should be scalable and based on a series of qualitative and quantitative triggers which, when activated, result in more strenuous, but not duplicative, oversight or regulation. SR regulation should consider existing mechanisms within particular financial industry sectors that internalize and absorb counterparty risks of individual firms (e.g., guaranty funds) and should not obstruct existing functional regulation that manages those risks. As each trigger is activated the analysis performed and regulatory involvement will become more detailed and for highly systemically risky entities could include capital requirements based on risk levels and uncertainty. Activation of the final trigger would result in resolution. **Step 1 – Screening to eliminate non-risky entities** Functional regulators of financial companies would be directed to: • Identify entities that have excessive off-balance sheet risk (relating to interests in entities that are not shown on their GAAP or regulatory financial statement balance sheets) • Report information on <u>only</u> those entities identified above to the SR regulator (SRR) for Tier #1 review as described below. • Strengthen their own oversight of potentially systemically risky companies with respect to enterprise risk management, measuring risk exposure, performing stress and/or scenario tests, control identification, etc.

	Step 2 – Measuring degree of systemic risk and applying appropriate oversight Financial companies that are not eliminated via the Step 1 screen would be subject to systemic risk regulatory review and classification by tiers. Tier #1: The SR regulator (SRR) would annually provide various numerical tests based on the systemic risk quantification by product line. These tests would include review of the relative size of off-balance sheet risk and unfunded commitments. Companies whose activities exceed a certain dollar threshold would self-determine if they exceed the numerical test, in which case they would be required to report certain consolidated holding company information to the SRR. Tier #2: If a company's SR exceeds a certain level based on the consolidated tests, and the SRR determines that existing regulatory scrutiny of the company's SR is not adequate to manage those risks, that company would become subject to additional monitoring (including monitoring of the number and amount of obligations to different counterparties), a basic level of reporting on its enterprise risk management, and potential risk auditing by the SRR. Periodic risk auditing would identify deficiencies and require affected companies to develop, within a given timeframe, a corrective action plan and to achieve compliance. The SRR may also perform criminal background checks on key holding company management. Tier #3: Companies that reach high levels of systemic risk would be subject to scalable capital charges depending on the level of systemic risk presented. Tier #4: Companies that reach very high levels of systemic risk (or that fail to achieve timely compliance to correct systemic risk deficiencies) would be subject to corrective action agreements to implement more robust enterprise risk management and capital standards at the holding company level. SR reporting could become quarterly. Tier #5: Companies that fail to implement corrective action agreements for enterprise risk management and capital standards would be subject to cease and desist orders. Companies that fail to try to fulfill corrective action agreements willfully or consistently in bad faith would be subject to civil penalties. Tier #6: Insolvent companies that are systemically risky, that are not otherwise subject to a resolution procedure, whose failure would create an unacceptable systemic risk to the economy, would be put into conservatorship or otherwise resolved by the systemic resolution agency. Companies would have the option to request a higher tier of oversight (for equivalency purposes). Companies should be able to petition to immediately lower their tiering upon taking action to reduce systemic risk, such as by reducing leveraging or raising more capital. Companies should also have an appeals process to review systemic risk determinations.
SYSTEMIC RISK AGENCY	Federal Reserve Board (in consultation with applicable primary regulators)

FUNDING	Congressional appropriations. If funding is necessary over and above general appropriations from Congress, funding for direct costs of systemic regulation, other than those related to resolutions, should be through scalable assessments on covered financial companies. Scalability should be based on the aggregate systemic risk of companies' systemically risky activities (*i.e.*, the measure should be the systemic risk of each of a company's activities, not the overall size of the holding company that could include many less systemically risky activities).
INSURANCE LEAD REGULATOR	For purposes of coordinating systemic risk oversight and insurance holding company resolutions, a lead insurance regulator for each insurance holding company should be identified by the states, based on consideration of the following criteria: • State with the largest number of domestic insurance companies; • State of largest premium volume (by domestic companies or by coverage written in the state); • State of domicile of top-tiered insurer in holding company system; • Physical location of the main corporate offices; • Insurance department expertise in the area of concern and experience of staff in similar situations; and • State whose regulatory requirements have driven the design of the group's infrastructure. The lead state regulator for an insurance group shall collect information on potential systemic risk, focusing on significant off-balance sheet, unfunded contingent liabilities over a certain threshold; and, report such information to the office of the federal systemic risk regulator.
INFORMATION FLOW BETWEEN REGULATORS	The Antifraud Network Act should be enacted to create appropriate privileges for information sharing among regulators. Expanded President's Working Group on Financial Markets (PWG) information sharing should also be enacted. With respect to information oversight for specific holding companies with a tier 3-6 systemic risk, the FRB should hold regular "Supervisory Colleges" with regulators of all regulated entities within group, to coordinate oversight and establish additional protocols for information flow among the members.
AVOIDANCE OF COMPOUNDING OF RISK BY AFFILIATES	The PWG and Supervisory Colleges should assist the FRB in developing standards to ensure that systemically risky holding companies' enterprise risk management standards include provisions for ensuring that affiliate risk taking diversifies holding company risk rather than compounds it.
SYSTEMIC RISK REGULATION FOR SUBSIDIARY COMPANIES	The overall goal of systemic risk regulation is to allow holding company subsidiaries to fail separately, not to eliminate or even reduce the possibility of a subsidiary failing.

Resolution of Failing Systemically Risky Companies

PCI supports creation of a federal resolution authority to address the potential failure of financial firms by allowing the government to resolve systemically risky financial companies *that are not otherwise subject to federal or state regulatory resolution.* We suggest that, in establishing a resolution authority, the Congress should establish in advance clear goals, process, and criteria for resolution, including:

- Provide an orderly unwinding of systemically risky failing firms to maximize resolution value;
- Activities should bear their own risk costs (no cross-industry subsidizations);
- Depoliticize resolutions – predetermine formulas and prioritization of claims (recognizing some claims take longer to mature);
- Avoid destabilizing markets
- Minimize moral hazards

Industries Should Pay Their Own Risk Costs: Resolution funding should be assessed separately for each financial industry. Industries should not subsidize each others' activities. Insurers, banks, and broker-dealers already have assessment systems to pay for the failure risks generated by their industries. To the extent that new systemic risks are being created by activities without government guarantees (investment banking, derivatives, etc.) then those industries should bear their own risk costs and have it factored into their pricing. In effect these industries should be compelled to internalize the costs they could impose on society in the event of failure. This minimizes moral hazards, cross-subsidies, and regulatory arbitrage; reduces market distortion and ensures accurate risk pricing; limits failures from contaminating other industries; increases the risk pool; and maximizes the incentives for each industry to work with its regulator to create the optimal balance between solvency protection and risk. Any assessments should be risk-based and only imposed on systemically risky entities not otherwise subject to risk assessments. Activities that are not systemically risky should be excluded from calculations for covered financial companies and assessments. To the extent any additional funding is necessary for holding company resolutions unrelated to a particular financial activity (this should be minimal), it should be systemic risk weighted/scalable and post-event.

Don't Punish the Innocent: The resolution agency should be able to manage a parent holding company's equity interests, but should not be able to reach down into affiliates subject to separate resolution authority. Diluting the assets of an insurer, bank, or broker-dealer affiliate would then unfairly subject the less risky competitors of that entity to potential assessments to pay the failed company's liabilities – potentially twice (once at the systemic risk level and a second time through the guaranty funds). This is a particular concern in protecting insurance surplus, which is necessary to cover long-term uncertain liabilities of policyholders, in comparison to banking liabilities that the resolution agency might be more familiar with that could be more immediate and quantifiable.

Retain Existing Contracts and Priorities: Insurance law prioritizing policyholder (and reinsurance) claims should be retained to ensure they are made whole before other creditors. Insurance contracts should not be repudiated except as absolutely

necessary to disentangle entities. Bridge insurers with separate charters should not be created and not given competitive advantages.

Avoid Perception of Conflicts: Resolutions should be determined by Treasury after consulting with the FRB and the primary regulators of any involved affiliates (such as an insurer's lead state regulator). Treasury should report to Congress and the President on any disagreements among involved regulators. In addition, the following elements should be included to avoid conflicts:

- Resolution funds should be managed by Treasury's designee (that is not a primary regulator).
- Resolutions should be performed by a separate resolution agency overseen by Treasury.
- Avoid regulatory moral hazard that requires an agency with primary responsibility for a particular market segment to resolve competing claims from other financial markets.

Thank you for the opportunity to provide the committee with information on the question of whether some financial services companies are "too big to fail" and potential actions to improve economic oversight. PCI looks forward to continuing to be a resource on financial services regulatory reform issues.

PCI Property Casualty Insurers Association of America
Shaping the Future of American Insurance

Impairment Experience of the Financial Services Industry

In brief

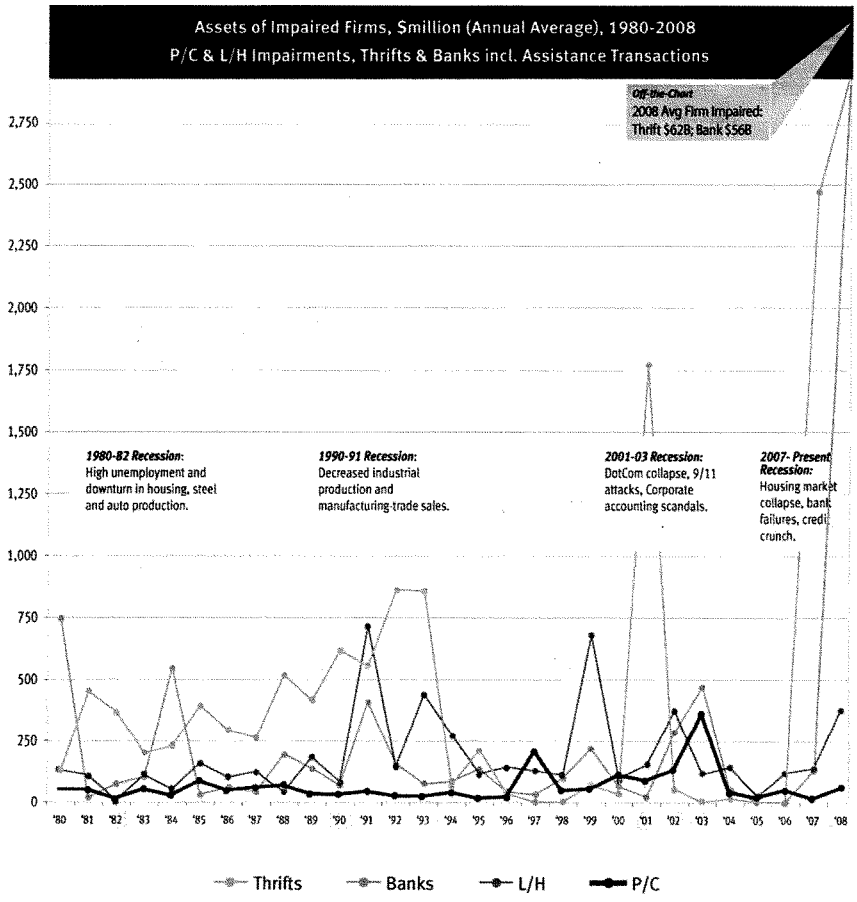
The property casualty insurance industry has historically experienced a consistent and low impairment rate that is uncorrelated with larger economic downturns.

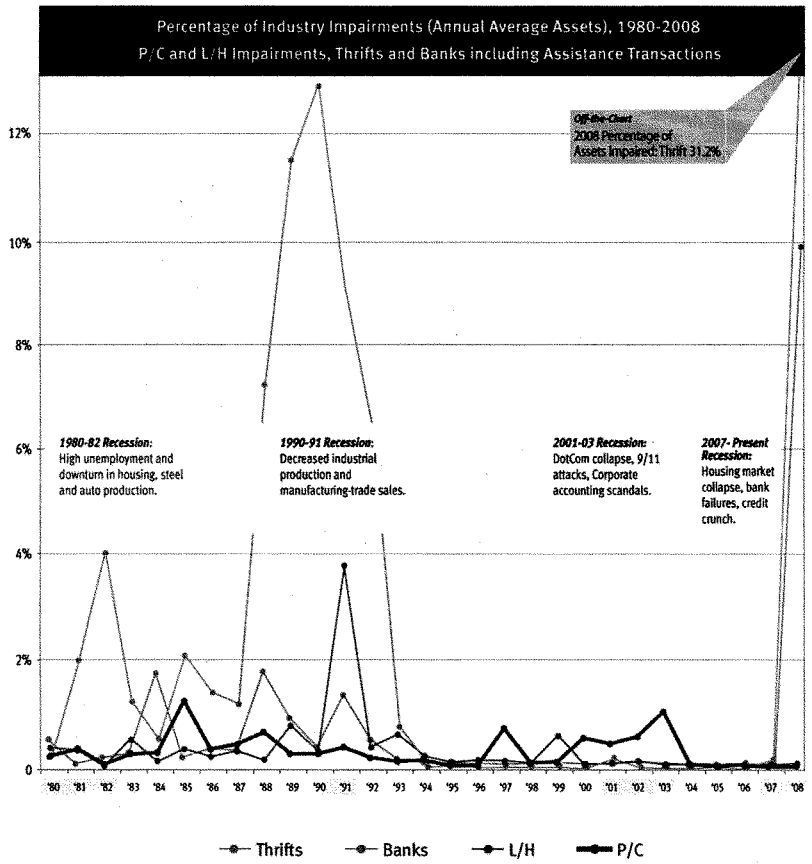
The property casualty insurance industry has historically experienced a consistent and low impairment rate that is uncorrelated with larger economic downturns. The tables and charts below indicate the recent and historical impairment activity over the last 30 years within four major sectors of the financial services industry: Thrifts, Banks, Life/Health, and Property/Casualty. Impaired firms are those requiring regulatory intervention.

The data clearly demonstrate that the insurance industry, particularly the property casualty insurance industry, experiences far lower average impairments than their industry counterparts. The Assets of Impaired Firms table indicates the average annual dollar amount of impairments in each of the four sectors. The Percentage of Industry Impairments table compares the impairments as a percentage of each industry's assets. The corresponding charts illustrate the level of impairment (in dollars and percentage) during four key periods of financial crisis over the last thirty years.

	Depository Institutions		Insurance	
	Thrifts	Banks	Life / Health	Property / Casualty
Assets of Impaired Firms, $million* *(Annual Average)*				
2008	$62,320	$56,477	$382	$51
2007	2,474	125	137	7
2006	0	0	118	42
2005	0	0	22	12
2000-2008	7,406	6,388	170	89
1990-1999	327	130	282	44
1980-1989	324	193	100	41
1980-2008	2,523	2,094	185	57
Percentage of Industry Impairments *(Annual Average Assets)*				
2008	31.18%	10.55%	0.06%	0.02%
2007	0.16%	0.00%	0.02%	0.00%
2006	0.00%	0.00%	0.01%	0.04%
2005	0.00%	0.00%	0.00%	0.01%
2000-2008	3.50%	1.18%	0.03%	0.30%
1990-1999	2.91%	0.22%	0.60%	0.19%
1980-1989	3.13%	0.57%	0.29%	0.39%
1980-2008	3.19%	0.65%	0.32%	0.29%

PCI is comprised of more than 1,000 member companies, representing the broadest cross-section of insurers of any national trade association. PCI members write over $176 billion in annual premium, 35.9 percent of the nation's property casualty insurance. Member companies write 43.8 percent of the U.S. automobile insurance market, 29.6 percent of the homeowners market, 32.8 percent of the commercial property and liability market, and 38.4 percent of the private workers compensation market.
2600 South River Road, Des Plaines, IL 60018 Telephone 847-297-7800 Facsimile 847-297-7800 www.pciaa.net


Assets of Impaired Firms, $million (Annual Average), 1980-2008
P/C & L/H Impairments, Thrifts & Banks incl. Assistance Transactions
Off-the-Chart
2008 Avg Firm Impaired:
Thrift $62B; Bank $56B
2,750
2,500
2,250
2,000
1,750
1,500
1,250
1,000
750
500
250
0
1980-82 Recession:
High unemployment and downturn in housing, steel and auto production.
1990-91 Recession:
Decreased industrial production and manufacturing-trade sales.
2001-03 Recession:
DotCom collapse, 9/11 attacks, Corporate accounting scandals.
2007- Present Recession:
Housing market collapse, bank failures, credit crunch.
'80 '81 '82 '83 '84 '85 '86 '87 '88 '89 '90 '91 '92 '93 '94 '95 '96 '97 '98 '99 '00 '01 '02 '03 '04 '05 '06 '07 '08
Thrifts
Banks
L/H
P/C



Source: A.M. Best Company; Office of Thrift Supervision (OTS); and Federal Deposit Insurance Corporation (FDIC).

Notes:

* Asset dollars are not inflation-adjusted.

Property Casualty Insurance Industry --

'In 2003, a spike in impaired assets was driven by Kemper Insurance Companies - caused primarily by deficient loss reserves and inadequate pricing, according to A.M. Best, accounting for over 70% of the year's aggregate impaired insurer assets.

'In 2008, the only property casualty insurers declared financially impaired were seven very small companies that did not maintain an A.M. Best financial strength rating. Four were mortgage title insurance companies. It is also notable that A.M. Best U.S. Property/Casualty Report indicates that over the last 40 years the majority of property casualty financial impairments were caused by either deficient loss reserves, inadequate pricing or rapid growth (as opposed to over-leveraged assets).

Thrifts -
'Through May 22, 2009, there have been four thrift impairments with assets of $14.8 billion.

Banks -
'Through May 22, 2009, there have been 32 commercial bank impairments with assets of $19.5 billion.

As of 5-22-09