

**WALL STREET TO MAIN STREET: IS THE CREDIT
CRISIS OVER AND WHAT CAN THE FEDERAL
GOVERNMENT DO TO PREVENT UNNECESSARY
SYSTEMIC RISK IN THE FUTURE?**

HEARING
BEFORE THE
JOINT ECONOMIC COMMITTEE
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WALL STREET TO MAIN STREET: IS THE CREDIT CRISIS OVER AND WHAT CAN THE FEDERAL GOVERNMENT DO TO PREVENT UNNECESSARY SYSTEMIC RISK IN THE FUTURE?

WEDNESDAY, MAY 14, 2008

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met at 9:30 a.m., in room SH-216 of the Hart Senate Office Building, the Honorable Charles E. Schumer (Chairman of the Committee) presiding.

Senators present: Klobuchar, Webb, and Brownback.

Representatives present: Maloney, Hinchey, Brady, and Paul.

Staff present: Christina Baumgardner, Heather Boushey, Chris Frenze, Tamara Fucile, Nan Gibson, Rachel Greszler, Colleen Healy, Bob Keleher, Israel Klein, Tyler Kurtz, Michael Laskawy, David Min, Robert O'Quinn, Jeff Schlagenhauf, Christina Valentine, and Jeff Wrase.

OPENING STATEMENT OF HON. CHARLES E. SCHUMER, CHAIRMAN, A U.S. SENATOR FROM NEW YORK

Chairman Schumer. Good morning, everyone. The hearing will come to order, and we're going to get started unusually and atypically, right on time here.

First, I want to thank you, Chairman Volcker, as well as our other witnesses—we have a second panel today—for coming to this hearing about the financial system and the steps we need to take to reform our regulatory structure.

Our discussion will be a broader one. We're not going to get into specifics. That's the real province of the Banking Committee—I serve on that, as well, and some of us on this Committee do—but rather, the broader regulatory questions that we face, given everything that's happening in our new financial world.

I'm worried that because things do not seem as bad as they did a month ago, we're already starting to become complacent about the critical need to address the regulatory and market failures that have had much to do with the troubling economic situation we find ourselves in.

The past year has been a stark reminder of the direct link between Wall Street and Main Street, between the health of financial markets, and the economic well-being of all Americans.

A year ago, most of us had never heard of CDOs and CMOs, and SIVs and of option ARMs and credit default swaps and auction-rate securities. Now we know that those who knew about those complex financial instruments clearly didn't know enough to protect consumers, investors, and our economy from them.

And we've learned too much about the central role these financial tools have played in the worst housing crisis since the Great Depression, the freezing of credit markets worldwide, and the onset of the current economic slowdown which probably more than half of all economists call a recession.

Financial innovation is vital, both for the health of our financial system and our economy, but it's just as vital that financial regulation keep up with innovation. Unfortunately, it has not.

In my view, this credit crisis is as much a failure of regulation as it is a failure of the marketplace.

The goal of regulation should always be to encourage entrepreneurial vigor, while ensuring the health of the financial system. We have, indeed, found that balance in the past, but it seems to have been lost.

We have a 21st century global financial system, but a 20th century national set of financial regulations, and that has to change.

To begin, we have to acknowledge that consolidation has transformed the financial industry. We no longer have any clear distinctions between commercial banks, investment banks, broker-dealers, and insurers that we did 60 years ago, or even 20 years ago.

Instead, there is a large number of financial institutions surrounded by many, many more smaller institutions, such as hedge funds and private equity funds with their own specialties. It's as though we have a handful of large financial Jupiters that are becoming more and more similar, encircled by numerous small asteroids.

A regulatory structure has to recognize that change, as large investment banks have come to act more like commercial banks, and especially now that they can borrow from the Fed's Discount Window, they need to be supervised more strictly.

We need to think very seriously about moving toward more unified regulation, if not a single regulator. We have too many financial regulators each watching a different part of the financial system, while virtually no one can keep an eye on the greater threats of systemic risk.

In the United Kingdom, they have a single strong regulator who has responsibility for the entire system and the authority to act when necessary.

Maybe a regulator with that authority could have prevented a debacle like the collapse of Bear Stearns, by acting quickly and forcefully before things unravelled.

In a certain sense, the regulator—the prime regulator of Bear Stearns—was the SEC. They're interested in investor protection and transparency, whereas the Fed, which has the primary jurisdiction over systemic risk, really didn't have much knowledge or ability to go look at Bear Stearns, so you had mismatched regulators for what needed to be done.

We have to figure out how to regulate the currently unregulated parts of financial markets as well.

For example, credit default swaps are a multi-trillion-dollar industry, almost completely outside the purview of regulators. Recently, there's been talk about creating a clearinghouse for credit default swaps.

I think this is an excellent idea and the sort of innovation we should be thinking about more broadly. I also believe we need to think about whether a unique exchange for these swaps might be an even more effective way to bring about greater transparency and limit systemic risks.

We must have greater transparency in the financial system—period. The credit crunch has been as much a crisis of confidence as it has been a real economic crisis.

Financial markets operate on trust and on the belief that participants have—that they can rely on the people they are entering into contracts with. As long as so many black holes remain in the financial system, it's going to be hard for that trust to be restored.

We also must involve our international partners. National regulations can achieve only so much in a global financial market. It does us no good to enact new rules here if other countries remain lax in their regulations or their enforcement.

The global financial regulatory system should not be the arithmetical equivalent of the lowest common denominator. This crisis and the complexity of our system requires much more.

And finally, we must put aside the *laissez-faire*, no-government-is-good-government mantra that we too often hear from this Administration and from many of my friends on the other side of the aisle.

Clearly, the market does not solve all problems by itself, and of course, neither does Government. That's why we need firm, forward-looking regulation to prevent the sort of crises we're facing now from occurring in the future.

I share with Treasury Secretary Paulson and Chairman Bernanke the hope that the worst of the credit crisis is behind us, but I'm not convinced that it's over. Whatever calm has been brought to financial markets today has been the result, largely, of extraordinary actions taken by the Federal Reserve.

Chairman Bernanke deserves credit, but the actions he has had to take are a sign of just how unprecedented and how troubling this credit crisis has been.

We cannot sit back, relax, and hope for the best. The American people, our economy, and the global financial system can't afford it.

[The prepared statement of Senator Schumer appears in the Submissions for the Record on page 52.]

Chairman Schumer. I'd now like to call on Senator Brownback for an opening statement.

**OPENING STATEMENT OF HON. SAM BROWNBACK, A U.S.
SENATOR FROM KANSAS**

Senator Brownback. Thank you very much, Mr. Chairman. Welcome, Chairman Volcker. Good to have you back. It's always a pleasure to see you.

I was talking to some individuals the other day, who had had some comments or had heard a speech you had recently given, and

I wanted to follow up in questioning, in the time period that I have with you, about that.

Mr. Chairman, I appreciate the topic. It's quite a broad one: Is the credit crisis over and what can the Federal Government do to prevent unnecessary systemic risk in the future? It sounds suitable, I think, for a well-planned series of broad-based hearings.

I certainly hope that we can take the time in the Committee to examine this subject in much more detail. It certainly seems like it's ripe for a discussion and something that we can work on collectively.

Obviously, much of the current economic slowdown can be attributed to dysfunctional financial markets over the past year, caused by turmoil in markets for asset-backed debt securities and obligations.

We have witnessed the collapse of a major investment banking firm, or near-collapse, but for the unprecedented action of the Federal Reserve Board.

Well, there's been general praise for the actions of the Federal Reserve, which I have joined. Questions have been raised about how close to, or how far outside the boundaries of the its authority the Federal Reserve's actions were.

I'd like to note that the Fed took onto its balance sheet, and therefore the taxpayers' balance sheet, risky, private-sector assets inherited from an investment bank, over which the Fed did not have direct regulatory oversight as part of the takeover of Bear Stearns by J.P. Morgan Chase.

Well, the Fed has the power to do so under a 1932 provision of the Federal Reserve Act, allowing the Fed to lend to non-banks under, quote, "unusual and exigent circumstances." It isn't entirely clear what constitutes such circumstances.

The Fed's recent actions introduce serious issues of moral hazard by signalling to risk-takers and financial markets, that if the dice do not turn up favorable, the Fed, and hence taxpayers, will provide a backstop.

The Federal Reserve has also created new ways of lending to depository institutions and to investment banks by setting up a new term auction facility and term securities lending facility.

The latter allows primary dealers to exchange less liquid securities at an auction-determined fee for some of the Fed's Treasury securities.

Recently, the Fed has allowed private-sector asset-backed securities as securities eligible for such transactions.

So, the Fed has basically been conducting some of its monetary policy by rearranging its, and therefore, the taxpayers' balance sheet, trading Treasury securities for securities that include risky, asset-backed private securities.

While I believe that the Fed's recent actions and activities have been creative and may have helped reduce tensions in domestic and global credit markets, I also take seriously the responsibility that Congress has in its oversight role regarding the Fed.

I think that we need to know more than we currently do about recent actions. For example, to my knowledge, we don't have a clear accounting of the assets that the Fed took onto its balance

sheet in the Bear Stearns J.P. Morgan Chase deal, or an accounting of the value of those assets.

Given the Fed's recent emphasis on transparency, it would be useful to know, but interesting that we don't.

One of our witnesses today, former Federal Reserve Bank Board Chairman, Paul Volcker, is certainly eminently qualified to offer perspectives, not only on the broad topic of avoiding system risk, but on the more narrow questions of whether or not the Federal Reserve acted appropriately.

Mr. Chairman, I look forward to the discussion and the questions with our witnesses.

[The prepared statement of Senator Brownback appears in the Submissions for the Record on page 55.]

Chairman Schumer. Thank you. I think we'll call on Mr. Brady, Congressman Brady, before Congresswoman Maloney, so that Congresswoman Maloney can get settled.

Congressman Brady is taking the place of Congressman Saxton today.

**OPENING STATEMENT OF HON. KEVIN BRADY, A U.S.
REPRESENTATIVE FROM TEXAS**

Representative Brady. Thank you, Mr. Chairman, very much. It's a pleasure to join in welcoming the witnesses before us today.

The recent financial turmoil and the consideration of appropriate responses are key concerns of policymakers, and I thank Chairman Schumer for calling this hearing.

I'd like to also express my appreciation for the service of Paul Volcker as Federal Reserve Chairman. His perspective is invaluable.

He was appointed by President Carter, in 1979, to deal with the serious and growing inflation problem that was wreaking havoc on the economy.

The magnitude of the problem can be seen in a number of statistics from 1980. That year, inflation was 13.5 percent. It pushed interest rates up, with mortgage rates well over 10 percent and rising.

A recession caused the Gross Domestic Product to decline, while unemployment averaged over 7 percent for the year. With inflation and unemployment both rising, the notion that higher inflation could lead to lasting reduction of unemployment was finally discredited.

As Fed Chairman, Mr. Volcker had the difficult task of sharply reducing inflation and restoring price stability, thereby laying a foundation for sustainable economic growth.

The Fed has maintained the policy of price stability since the early 1980s, leading to an era of low inflation, low interest rates, and low unemployment.

The economic growth of the last 25 years would not have been possible without the cornerstone of price stability laid down under Mr. Volcker's tenure.

More recently, there have been concerns about whether inflation may be a rising threat to future economic growth. There have been concerns that earlier policies may have contributed to the housing

bubble and resulting debacle in mortgage-backed securities and related investments.

In addition, a variety of new financial instruments have been created, generating risks that were poorly understood, even by the most sophisticated bank executives on Wall Street. As a result, after the bubble burst, banks have had to make massive writedowns, and then in response, the Fed has loosened monetary policy and resorted to a series of innovations and extraordinary actions, including the rescue of Bear Stearns last March, amid serious distress in the financial markets.

I will conclude with this: Financial innovation and the recent financial turmoil have made clear the need for financial regulatory reform. The issues are very complex, and the debate about regulatory reform will likely go on for many years.

As a layman, it seems to me that our financial markets and their instruments tend to move with the speed and agility of the matrix, yet Government regulation, by nature, and regulators tend to move with the speed and agility of John Madden, whom I love by the way.

But the point is that—my concern is that whatever direction we head, that our regulators not micromanage each instrument and each market, but put in place the transparency and the standards that better allow investors and the public to monitor and short-circuit such crises before they occur again. That is our challenge before us. Mr. Chairman, I yield back.

Chairman Schumer. Thank you, Congressman Brady. Last, but not least, Vice Chair Maloney.

OPENING STATEMENT OF HON. CAROLYN B. MALONEY, VICE CHAIR, A U.S. REPRESENTATIVE FROM NEW YORK

Vice Chair Maloney. Thank you so much. I first thank the Senior Senator from the great State of New York for his leadership on this issue, and New Yorkers are equally proud of Chairman Volcker and his distinguished service to our country.

We are thrilled to have you here today. We all look forward to your advice and your statements and your wisdom.

At the core of the ongoing liquidity crisis is the decline in home prices which is causing banks to readjust their balance sheets and to buildup capital.

Congress is currently focusing its attention on keeping families in their homes and stemming the deepening decline in home prices. The crisis in the housing market has brought to light the inability of some of our most sophisticated and respected institutions to measure their exposure to opaque assets and manage the risks associated with them.

Untangling the DNA of assets has become increasingly difficult for investors. We clearly need greater transparency for complex investment products to assure a smoothly functioning market.

Our entire regulatory system is also in serious need of renovation because financial innovation has surpassed our ability to protect consumers and hold institutions accountable.

In our rather fragmented system, financial regulators do not have authority to broadly address systemic risk. The Financial

Services Committee will soon turn its attention to rethinking financial services regulation.

Meanwhile, the Treasury Secretary has a sweeping proposal for revising the Federal regulation of all financial institutions. That plan would grant the Federal Reserve power to serve as an over-reaching market stability regulator, with the ability to collect information and require corrective action across the broad spectrum of financial services.

Our current system of multiple regulators does leave big holes that a super regulator could plug. For example, the unwillingness, up to this point, of the Federal Reserve and the SEC to require working capital limits has been criticized as adding to risk-taking.

Only now has the SEC joined other Federal regulators in working with the Basel Committee to extend the capital adequacy standards to deal explicitly with the liquidity risks.

The Bear Stearns rescue also exposed the lack of Federal regulatory authority to supervise investment bank holding companies with bank affiliates, as the Fed supervises commercial bank holding companies.

Thus, investment bank holding companies don't have to maintain liquidity on a consolidated basis. In the wake of the Bear Stearns debacle, SEC Chairman Cox has said that investment banks can no longer operate outside of a statutorily consolidated supervision regime.

Giving investment banks access to the Fed's discount window—which was created for depository institutions—creates challenges, since they are not regulated like depository institutions. In particular, they have no restrictions on how highly leveraged they can be.

We need reforms, but the Treasury plan is so sweeping that it risks possibly being disruptive, while we are working so very hard to stabilize our economy. Moreover, it risks eliminating regulatory voices that should be heard.

The American system of Government relies on checks and balances, and we can all think of instances when the lone voice of a Federal regulator has pushed the group to an action that was unpopular, but proved to be right.

We should focus first on targeted reforms with maximum effect. Improving the transparency and accountability of trading and credit default swaps and derivatives is one possible example.

A key factor that apparently pushed the Fed to rescue Bear Stearns was concern about a domino effect from the interlocking relationships between thousands of investors and banks over credit default swaps, which are presently traded by investment banks off any exchange and without any transparency.

Requiring the use of exchanges and clearinghouses for credit default swaps and derivatives is possibly worth exploring, and I look forward to your comments on it.

Mr. Chairman, I thank you again for holding this hearing and for your leadership for New York and for our economy and so many creative ways. And again, it is a great honor for this Committee to have Chairman Volcker here today.

Everyone is asking me in New York, what does Chairman Volcker have to say about what is happening; so today, we get an

opportunity to hear from you. We are delighted by your presence, and thank you again for your service to our Nation.

[The prepared statement of Representative Maloney appears in the Submissions for the Record on Page 54.]

Chairman Schumer. Thank you, Vice Chair Maloney. Now to our first witness; Paul Volcker is truly one of the most esteemed public servants in American recent history, a giant of financial regulation.

He is a former Chairman of the Board of Governors of the Federal Reserve System, where he served from 1979 to 1987. After retiring as chairman of Wolfenson and Company, Mr. Volcker served as Chairman of the Board of Trustees of the International Accounting Standards Committee from 2000 to 2005.

He chaired the independent inquiry into the United Nations Oil-Food Program in 2004, and he's also professor emeritus of international economic policy at Princeton University. Chairman Volcker, we're delighted you're here, and thank you for going out of your way to come.

STATEMENT OF HON. PAUL A. VOLCKER, FORMER CHAIRMAN OF THE FEDERAL RESERVE BOARD OF GOVERNORS, WASHINGTON, DC

Chairman Volcker. Well, thank you, Mr. Chairman, ladies and gentlemen. We had a couple of conversations about coming here, and you emphasized that you looked forward to informality in this hearing.

Chairman Schumer. Correct.

Chairman Volcker. And I appreciate that. I'll just make a few brief comments, if I can, which duplicate some of the things you've been saying, to kind of help set the stage; but I would emphasize at the beginning, I do not see any reason for complacency about recent market developments, however much, we can welcome a little bit more calmness at the moment.

Now, we are in most difficult and complicated economic and financial circumstances, and we shouldn't doubt that.

I would emphasize a point that we often lose sight of, that, in the background, this is not just a financial problem; it is an economic problem.

We have had an unbalanced economy. This country has spent some years spending a lot more than it's been producing. It's carrying out a higher level of consumption, relative to GNP, than we could sustain, and that adjustment had to be made sooner or later.

I think we're probably in the midst of making it, but it is a difficult question.

That's in the background. In the foreground is the new financial system that a number of you commented on: less reliant upon banks, more reliant upon the open market, a more fluid system. It's certainly heavily engineered.

You and others have said, Mr. Chairman, that you look toward more transparency, and it's hard to argue against transparency, but I have to tell you, this new financial system, with all its enormous complexity, gives rise to a certain opaqueness that it is almost impossible to penetrate, so I don't think we're going to find all the answers in transparency.

There's kind of a symbiotic relationship between this new financial system and the unbalanced economy. The new financial system was so fluid and so effective in some ways that it enabled us to finance the excess in spending.

We didn't have to save when people thought they had other ways of finding money. The subprime mortgage phenomenon is the prime example of financial engineering leading to a way to finance consumption.

Well that's broken down, and to oversimplify, I think we are seeing a system in which the mathematicians, basically, have taken over—the financial engineers. Combine that complexity and opaqueness with a supercharged compensation system, and you had great incentives for risk-taking.

And at the same time, you had a basic breakdown, I think, in the discipline of credit analysis: The system developed in a way that's trading-dominated. People didn't worry so much about the quality of the paper, so long as you could pass it off on somebody else in a hurry.

Chairman Schumer. Right.

Chairman Volcker. And there was a lesser sense of vulnerability.

As a general, sweeping conclusion, I would have to say that, under stress, this new system has really failed the test of the marketplace. We are here because the new system has, in effect, broken down.

That put the Federal Reserve front and center in dealing with a crisis. It's obviously reacted in unprecedented ways, as has been mentioned here, with considerable success, but it leaves us with some big unresolved issues which you have all already mentioned.

What is the proper role of the lender of last resort? The traditional framework has been the banking system, heavily regulated, on the one side, has access to the lender of last resort, as a protection mechanism. Now we have the lender of last resort, rescuing sectors which are not subject to heavy regulation, and that's an incongruity that I think has to be corrected.

A little more subtle, but also mentioned by one of you, the Federal Reserve has taken on its balance sheet—not just the Federal Reserves, it's other central banks in Europe. They have become, in particular, supporters of the mortgage market.

They've done it in order to react to the current crisis, but we have to ask ourselves, what are the implications for a central bank getting involved in supporting particular sections of the market?

I understand that there are demands now, that they get into the student loan market, which is under stress, and maybe some other year, it will be some other part of the market. That has not been in the tradition of central banks, and I think what's at issue here, in the long run, is the independence of the central bank.

If it is going to be looked to as a rescuer or supporter of particular sectors of the market, that is not a strictly monetary function in the way it's been interpreted in the past.

And then there is, of course, the question of the Federal Reserve's role, or anybody's role in supervision. I know from experience—it's obvious that regulation has inherent problems; it's awk-

ward, arbitrary, backward-looking often. Apart from that, the life of a regulator is not a happy one.

When things are going well, nobody wants to be regulated.

Chairman Schumer. Right.

Chairman Volcker. And the resistance of the market to being regulated is transmitted quite readily into the political process when things are going well.

When things are going bad, everybody asks the regulator, where were you? Well, he wasn't there, in part because of the inherent difficulty of effective regulation when things are going well.

There have been breakdowns in supervision and regulation here; I don't think there's any doubt about it.

But beyond the Federal Reserve and beyond supervision and regulation, let me just make my own list. There are other issues involved here: Credit rating agencies; accounting; the role of market-market and fair-value accounting.

I wonder, in this situation, going back months ago, where were Fannie Mae and Freddie Mac? Here are institutions that have been created to support and facilitate the mortgage market, and in pursuit of their private property objectives, they strained themselves to the point that when the crisis comes, their ability to act is limited.

How do we restore credit analysis? What about the compensation system?

These are not very easily soluble problems, and I would conclude with the point that you just made, Mr. Chairman, that we're not going to solve these problems by domestic action alone. This is an international market, and we're going to have to work together with others.

I don't think that's an impossible challenge. There's been a lot of progress in that area recently.

This crisis clearly goes beyond the boundaries of the United States. It's clearly recognized in Europe; I think it's recognized in Japan, and there is a lot of basis for hope that we can get together on reasonable regulatory approaches, as we already do in some areas, with other major financial centers.

[The prepared statement of Hon. Paul A. Volcker appears in the Submissions for the Record on page 56.]

Chairman Schumer. Well, Mr. Chairman, thank you. I recall, in my House days on the Banking Committee, when you were Fed Chairman. There's only one thing that's changed; your acuity and your being able to summarize succinctly, but with just laser-like analysis, is still there.

But the rules have changed and you don't have your big cigar, so you don't have all the smoke coming in front of you.

Chairman Volcker. I don't even miss it, which is something I never thought was possible.

Chairman Schumer. See, regulation moves onward.

[Laughter.]

Chairman Schumer. But, in any case, it is great to hear you, and I have so many different questions.

Your analysis is troubling and sort of puts us in a different way. You know, when I look at this, I sometimes say the international

aspects are the most difficult, but you're saying, no, we've had good progress there.

The difficulty here is just the complexity of these markets and the inability of regulation to almost catch up. Transparency doesn't solve the problem, because, in a sense, the markets are fragmented and opaque in themselves.

That's worrisome and troubling, and something we're going to have to think about a lot.

Chairman Volcker. I have, just as a homely example, looked at a couple of annual reports of major financial institutions, recently. They are very thick.

And if you can keep awake while reading them and understanding them, you're a better man than I am, and it reminds you that the executives of these companies, I think, to put it mildly, have great difficulty in really understanding the amount of risk and complexity involved in their organizations.

Chairman Schumer. Right. I agree with you. First—and you can give a relatively quick answer here—the Federal Reserve did take the radical step you talked about it, to prevent the collapse of Bear Stearns.

Some people have said they've overstepped their authority. Do you think they had any choice? Could they have done it differently? Do you basically agree with what Chairman Bernanke did, given his limited abilities ahead of time?

Chairman Volcker. I was not there, but I can imagine that they were faced with a problem, and with a very short timeframe, worried about the contagion from the loss of Bear Stearns which was thrust upon their consciousness with suddenness, very quickly, and the interaction of a major investment banking firm—it's interesting that it was the smallest of the major investment banking firms—nonetheless created the possibility of a severe systemic crisis and difficult circumstances, so I can certainly understand why they felt they had to act.

Chairman Schumer. Do you think we have to follow up now, and does this almost, by definition, require us to re-examine how regulation is done?

Chairman Volcker. Absolutely. In a way, this crisis forced attention to what existed, in fact, already. The banking sector, which was protected and regulated, had gotten relatively smaller. The other sector had gotten larger and larger, but legislation and banking regulations had not caught up with that fact. Now, you're forced to look at it.

Chairman Schumer. Right.

Chairman Volcker. That's easy to say.

Chairman Schumer. Hard to do.

Chairman Volcker. What is an investment bank? Who is protected; who is not protected? It's put in stark contrast, when you think back to long-term capital management. This wasn't even an investment bank; it was a hedge fund.

My God, there are 40,000 or 50,000 hedge funds in the world, and this was supposed to have been a very sophisticated one. Have we got a financial system that cannot stand the particular loss of one hedge fund, with a relatively concentrated number of creditors?

That is a pretty sad commentary on the basic framework of the financial system.

Chairman Schumer. Right, and frightening, in a certain sense. The interconnectedness and, as you say, the complexity and opaqueness, allow a small flea on a tail of a dog, to have the whole system sort of collapse.

Let me ask you about two specific issues and just get your thoughts on them. I have been moving in the direction and talking about consolidating the system of regulation. When you have the combination that you've talked about, to have the regulators all chopped up in 25 different pieces, doesn't make much sense. What do you think of that?

Second, these swaps and derivatives, in general, as you say, are as opaque as could be, and difficult, and transparency may not solve much, but there is a lot of talk about having some kind of clearinghouse, so that trades don't just occur among two parties, but at least a larger number of parties who are in the general area, get to see what's going on.

What do you think of each of those ideas?

Chairman Volcker. Well, let me take the second one, first, because I can give you a briefer answer. I'm not an expert in these kinds of things, but this is one of the weak points, I think, in the present financial system, that you do not have a clearinghouse where a potential loss can be absorbed over a large number of participants.

Until recently, the settlement arrangements for this explosion in derivatives, have been very uncertain, in my understanding. That's been cleaned up, fortunately, to some extent, but by and large, there's no clearinghouse for most credit default swaps, in particular, which is, I think, the biggest point of vulnerability, so, yes, I think that is a priority.

Now, I won't say much more about it, because I'm not an expert in that area.

Chairman Schumer. Good enough.

Chairman Volcker. On consolidated regulatory authority, of course, this is a big issue. The English thought they got it right some years ago. They put it all in one big agency, had some liaison with the Central Bank, but not apparently, close enough.

As soon as it was tested, it didn't pass the test very vigorously, and the admiration for that system is somewhat diluted and leaves open the question.

I'll illustrate the difficulty, I guess, without an answer: From my point of view, it's always seemed rather clear, maybe even obvious to me, but I'm biased, that the Federal Reserve ought to be the principal financial supervisor, given its broad responsibilities.

Partly because of its responsibilities as lender of last resort, but also because of its independence, I think it's in a better position to resist political pressures on regulation. It also has a sense of continuity and the place of regulation within the broader economic context.

So, I would say, yes, we need more uniformity, and it looks like the Federal Reserve seems to be the logical candidate.

Chairman Schumer. So, one place you might look to is, give them more authority over holding companies of so-called investments.

Chairman Volcker. That is one way to do it, but now I have a certain hesitancy. How much do you want to give to the Federal Reserve? If you make them, to go to the extreme, the sole regulator of financial stability considerations, which would include what you're saying, it becomes an even more powerful agency in the United States.

It's getting into areas that are not typically thought to require the degree of independence that monetary policy does, so what does that mean for the structure of the Federal Reserve? I'm sure it means one thing, administratively—the Federal Reserve is not equipped to do it now.

Chairman Schumer. Right.

Chairman Volcker. And it would have to be reorganized and to the degree the Federal Reserve takes on more responsibility, and even without that, I would urge the Congress to make some arrangement where within the Federal Reserve there is an official, presumably subject to, I guess, Congressional confirmation; that is the chief supervisory regulator.

Now, maybe he's on the Federal Reserve Board. It could be the Vice Chairman of the Federal Reserve Board.

But there has to be somebody there who's accountable, more directly than is the case at the moment when you begin combining these agencies, at least in my view. You've got to have stronger staff, you've got to be able to pay some of these mathematicians and experts to get it on your side, instead of on the other side, or at least to match the other side.

So, there are all kinds of interesting questions, including whether the Federal Reserve really needs to be the sole supervisor.

There's something to be said for the Treasury outline. I think it was interesting.

Chairman Schumer. Which outline?

Chairman Volcker. The one announced by Secretary Paulson where they want to divide up the supervision by function. Take business practice, consumer protection, investor protection and give that to a new super SEC, I guess; create a super safety and stability regulator, and then have the Federal Reserve oversee it in some sense.

The obvious question that many people have pointed out to that is, if the Federal Reserve is going to oversee it, it better get more involved than just coming in after a crisis.

So I don't think that resolves the problem, but it's an interesting suggestion.

Chairman Schumer. Thank you.

Representative Brady.

Representative Brady. Thank you, Chairman, and thank you, Chairman Volcker.

I worry a bit about piling too much on the Federal Reserve's plate for fear that they will lose sight of their core mission. I know that in Federal agencies when Congress tends to create that mission for them, they often are ineffective in actually doing what we sent them up to do. That's a concern.

The reason I really appreciate you being here today, is, I think we've really reached the point where we ought to be applying Noah's principle, which is, we need fewer people telling us it's raining and more people picking up a hammer and helping us build an ark.

Your perspective is, I think, to help us identify the types of reforms that can help us build a regulatory environment that maximizes the up side of capitalism and helps prevent the problems we have today.

Forgetting for a moment, who would be the regulator, or if it would be a consolidated regulator, in your view, what is the most important reform that Congress and the executive branch could bring to bear on this ever-changing, complex, international financial market? What's the most important? Where would you start on the regulatory side on this issue?

Chairman Volcker. Well, I would start from the Congressional perspective, I think, to decide what we were just discussing. What should be the broad framework for that regulation? Should it be one agency? Should it be maybe two agencies along the lines of the Treasury proposal, one for business practices and one for safety and soundness?

That's kind of an alluring suggestion to me, but then as we just discussed, you can't or should not—anyway, in my view, remove it all from the Federal Reserve. They have to be rather intimately involved.

Whether they have to be the operating regulatory agency in all detail is a question that needs to be resolved. But don't separate them, don't insulate the regulator from the lender of last resort.

I think the British experience is relevant—and it's not just that. There was an incident in Canada some years ago, where the most important regional banks in Canada, together, were in danger of failing. The Bank of Canada was called in for a rescue, and they had no supervisory authority, were obviously unfamiliar with the situation, but yet they were deemed responsible for maintaining the stability of those institutions.

That is not a sensible system, in my view.

Representative Brady. In part of the discussion of how best to regulate and who should do it, what is the goal we want them to accomplish? Where do we want them to start?

You mentioned that the current opaqueness in the system is a great contributor to the problem. And you sort of inferred transparency is not necessarily the solution, but is it your point that transparency would help.

When you've got CEOs of major financial institutions who don't understand the complexity of their own purchases and risk-taking, surely we need to have more transparency, so that average investors understand—and regulators and Members of Congress, can understand what is happening in the market at a given time, don't you?

Chairman Volcker. Well, yes, but I don't know how you get it. Take these CDOs that have been mentioned. These are big packages of mortgages and other forms of debt that some transformer has put into a big package.

They may or may not individually have some credit ratings, but a lot of them have not had much credit discrimination these days, because the originator doesn't take any risk, so he's not worried about the credit. The transformer doesn't take much risk because he's going to sell it.

They're put into a huge package, turned over to a credit rating agency that is going to use the same mathematical formulas and algorithms for evaluating the package that the originator used.

Representative Brady. Sure.

Chairman Volcker. Because those are the ones that exist. They haven't looked at the individual credits, and then they sell it in the market. They may sell it to some municipality in Norway or whatever, to UBS in Switzerland, or obviously, to pension funds in California or wherever.

And nobody's really looked at it. You know, transparency, all right, what's the transparency? You're going to list 6,000 individual mortgages that are in the package? Who's going to look at them?

Nobody really has, now, responsibility for them, or cares, in some sense, so long as you can sell it. They've been told that, you know, mathematical analysis says it's not likely that more than 5 percent are going to go bad, and another 10 percent will have difficulty, and the other 70 percent are going to be triple-A credits.

Well, that's fine, until somebody begins questioning whether that's true, in the middle of a crisis, and you have a mess.

Representative Brady. Thank you, Mr. Chairman. I appreciate it.

Vice Chair Maloney [presiding]. Thank you. What should the Fed have done differently, if anything?

Chairman Volcker. Pardon?

Vice Chair Maloney. What should the Fed have done differently with the Bear Stearns situation?

Chairman Volcker. I can't say how it could be done differently. They were faced with a situation to which they reacted, and they reacted by drawing on emergency powers and interpreting existing law in a way that permitted them to act, and act forcefully.

The more relevant question, I suppose it seems to me, is could more effective supervision by the Federal Reserve, or by other agencies—earlier—have avoided the crisis in the first place? Well that is a proposition to be examined. My answer would be: Not entirely, because supervision and regulation is not always that effective.

But I think there are lessons to be learned in supervision and regulation in this case, and some parts to me seem fairly obvious. How did these banks— why were they permitted to set up these off-balance sheet entities which may or may not have had some formal relationship to the bank? They certainly had enough relationship to the bank, so when they got in trouble, the banks felt responsible for them, but yet they were not regulated and they did not hold any capital against them, or adequate amounts of capital against them. Why did that happen against the experience in another area of Enron, WorldCom, and all these other places that had similar off-balance sheet accounting entities?

Vice Chair Maloney. Thank you.

Chairman Volcker. There are lessons to be learned here, without any question.

Vice Chair Maloney. Can you elaborate on the question that you posed in your testimony about whether it is wise for such far-reaching responsibilities—oversight of commercial and investment banking—to rest within a single organization like the Fed?

And related to that, how do you think vesting all of these regulatory responsibilities at the Fed would impact its ability to conduct monetary policy and also maintain its independence?

Chairman Volcker. Well let me draw a distinction; it may be subtle, but I think it is real—a distinction between regulatory and supervisory responsibility, and a willingness or demands to intervene in particular sectors of the credit markets.

The Federal Reserve, as are other Central Banks, is obviously taking into its balance sheet a lot of mortgages these days. One of the critical elements of this crisis has been a freezing up of the mortgage market. So the reaction has been, “all right, let’s try to unfreeze the market, and we’ll buy a lot of mortgages.”

Well the creators of the Federal Reserve System would be rolling over in their graves thinking that the Federal Reserve is buying mortgages. In those days, they couldn’t do anything except buy short-term commercial paper. They couldn’t even buy a Treasury Bond, much less a Mortgage Bond.

And when I look at it I say: Look, the mortgage market was a problem. There is no doubt about it. But where were Fannie Mae and Freddie Mac? These are two Congressionally created agencies with the specific responsibility for encouraging the stability and flexibility of the mortgage market.

A crisis comes along, and they say: Well, we are already overstretched; our capital exposure is already strained; we can’t do anything to help.

Well what kind of a system have we got when the agencies who are supposed to be reflecting the public interest in the mortgage market are out serving the interests of their stockholders? As they see it, that’s understandable—

Vice Chair Maloney. That’s a very good question, a very, very good question.

Are we just—could you comment on our place in the world economy and the need for flexibility for our financial institutions to remain the leaders—we hope—in the world economy, or certainly one of the powerful voices in it, and a complaint that I hear sometimes that more supervision and regulation would stymie our creative ability to be—

Chairman Volcker. Yes, I know.

Vice Chair Maloney. You have heard the same thing?

Chairman Volcker. Yes, I have heard that.

Vice Chair Maloney. Would you comment on it, please? And then my time is up.

Chairman Volcker. No, but I think you’ve just got to look at this from the other direction, that these problems are common to developed markets all over. The United States may have been in the lead in some of this market development, but it is not alone.

Some would argue the principal capital of the world capital markets these days is in London, not in New York. I hope that's not true, but in any event, it's international.

And you can't have certain types of regulation anyway, effectively in the United States because the business can be done elsewhere. It's already being done elsewhere. But I do think there is a common interest among developed countries with developed markets to approach this together. And that is not new.

People told me 20 years ago when we started out uniform capital standards for commercial banks, it couldn't be done. Forget about it. Well, it got done. And you do have relatively uniform capital standards today.

We now have, remarkably, the approach of uniform accounting standards around the world, another area where 10 years ago people in the United States said, "forget about it; our accounting standards are good; the rest of the world can follow our accounting standard."

Well that is not the view anymore—quite correctly—and a lot of progress has been made in those areas. There are efforts toward standardizing and improving auditing standards around the world.

There are other examples of this kind of cooperation. Some people came in to see me the other day from the European Parliament where they are working hard on regulation supervision of hedge funds and private equity funds. They are ahead of us in terms of eagerness to get some sensible regulations.

So we have to work with these people because I think there is a definite common interest. And in this crisis—the biggest bank in Switzerland has been in an epicenter of this crisis. Do you think the Swiss are not going to be interested in developing some common standards? Well I think they are going to be.

So I think you have to look at it from that direction. This is a global problem.

Vice Chair Maloney. Thank you so much. My time has expired. Congressman Paul.

Representative Paul. Thank you, Madam Chair.

Welcome, Chairman Volcker. It's good to see you again. Like Chairman Schumer, I remember well the discussions we had back in the 1970s and early 1980s regarding another financial problem at the time. But back then, we also dealt with the Monetary Control Act that we debated rather vigorously, and I was concerned about Reserve requirements going down to zero, as well as the Fed being able to buy just about anything to hold as an asset and as collateral.

I think the ongoing problem we have today is related to that attitude, because not only does the Fed now buy housing securities which keep going down in value, but now they are talking about buying credit card securities, car loan securities, student loan securities. I mean, that does not reflect a very sound economy.

I think if we do not address that subject some day, we cannot just claim that all we have to do is have more regulations. I think we have to define some of the issues rather well, and how do we get in the trouble. What is the problem?

One thing I don't think we ever do is define "capital." We talk about capital, but in capitalism in the free markets, capital comes

from savings. Well we don't have any savings. Capital comes out of thin air. And we have had the luxury of creating as much so-called capital as we want because we were able to issue the reserve currency of the world.

You mentioned the problem that we have is over-consumption. Well that wouldn't occur if you had a commodity standard of money because it holds you in check. You know you have to pay your current-account deficit routinely. But now there hasn't been. And this of course, in my estimation, leads to the gross distortion, the gross malinvestment, and the huge amount of debt that we have.

So the consensus seems to be what we need, without asking the question how did we get here, is we need more regulation. And everybody said, well, bailing out Bear Stearns was just wonderful.

Well that to me is sort of like saying, you know, if you have a drug addict having a withdrawal symptom, you give him another fix and he feels good; then everything is going to be OK.

So I don't think that can be that reassuring to us because we have so many problems that we still face. I believe in regulation, but I don't believe for a minute that it's the lack of Government regulation that is our problem. It was the fact that the Government had license through the Federal Reserve to distort the market, create capital out of thin air, distort interest rates, cause the malinvestment, and the excessive debt—and the market is a good regulator.

The market, through interest rate changes, gives us signals that we should follow. But we don't have that anymore. But just to say, well, we need more regulation, I think it is sort of like saying that we need regulations for something that's unregulatable because the system is so artificial and has nothing to do with the market economy.

So I really fear when I hear statements: Well, it's the free market that is the problem, and rather than asking, where did the bubble come from? I think it is very, very precise and very clear where financial bubbles come from, and we have to deal with that.

But I have one very minor question. You might not want to comment on this, but I had read one time, many years ago, that you might have had some reservations about the breakdown in the Bretton Woods Agreement. If you can make a brief comment on that.

The other question that I have is: Could you compare the crisis we face today to the one that you faced in 1979? Because you did have a huge crisis which required saving the dollar. That could have gotten out of hand. Interest rates were up to 21 percent.

In today's prices of gold, gold was like \$2,500. It was huge. Yet today, I see some conditions that may well be worse when you look at our foreign indebtedness, our domestic debt. So are there any similarities, or are there any comparisons? And what kind of shape are we really in?

Chairman Volcker. Well in your passing question about Bretton Woods, I did have my reservations about it. I was in the middle of that breakdown. It doesn't mean I was happy about it.

The way it all came out didn't meet my hopes at the time, but changes had to be made. But I did have reservations.

Look, supervision and regulation is not going to solve all these problems. You're quite right. You have to get the basic structure of the system right.

One point of concern which I think touches upon what you are saying is you cannot lose sight of the fact that if people get used to the notion that financial institutions—the creditors of financial institutions—are going to be protected, that will affect their behavior, and they will take more risk than they otherwise will take.

That is what is at issue in the whole question of the lender-of-last-resort.

Now I can't conclude from that that because that risk exists, and the more you extend the lender-of-last-resort the greater it is that we shouldn't have a lender of last resort. Because the risks of the breakdown on the other side are too great.

But how do you achieve a balance? That is partly where regulation and supervision has to help. If you are going to protect those institutions, they will take risks and their creditors will take risks that would not take place in a different kind of market.

So the supervision and regulation has to come in and balance that by insisting that you have to keep higher capital than you would otherwise keep. You've got to keep more liquidity than you would otherwise keep. And you want to do this in a way that's obviously least awkward and least obtrusive, but you've got to do it because otherwise people will run to extremes.

There's financial volatility in all these markets, whether they're protected or not. That's the history of financial capitalism. But you want to restrain as much as you can the excesses, and that does require if you've got protection on the one side you've got to have supervision on the other side.

Representative Paul. Thank you.

Vice Chair Maloney. Senator Klobuchar.

Senator Klobuchar. Thank you.

And thank you, Chairman Volcker. You were talking, at the beginning of your testimony, about how this isn't just a financial crisis, it is an economic crisis as well.

Could you comment a little bit on the weak dollar and how you see that fitting in? On the one hand, it has helped with our export market. I've seen that in my own State of Minnesota where the papermills in Canada have shut down and we're going great guns in Minnesota.

On the other hand, the weak dollar has been blamed for skyrocketing oil prices and for triggering a foreign capital flight and draining U.S. credit markets.

So what do you think? And do you believe there are policies we should pursue?

Chairman Volcker. It's a perfectly ambiguous situation because we've gotten ourselves in a situation where—I don't think it's going to cure it; a depreciation of the dollar against some currencies anyway, was probably necessary to get our economy rebalanced. And that is going on.

I think underneath the surface of all this, consumption is being restrained, as it has to be. Exports are doing very well, as they must do if we're going to deal with the external balance. And we'd like to have an economy that can move ahead with a stronger ex-

ternal position and a more balanced consumption, and lay the base for a sustained recovery.

But the dollar is important not only because of its inflationary implications in the United States at a time when there obviously are concerns about inflation, and should be, but because the dollar—to go back to Mr. Paul's questioning—has been the linchpin of the world international monetary and financial system. And if there is a real loss of confidence in the dollar, I think we are in trouble in terms of sustaining open markets, free trade, continuing economic advance generally.

So, that is something that has to be watched. We have to accept the fact that some depreciation has taken place, but we don't want it to get out of hand.

Senator Klobuchar. We had a hearing on sovereign-wealth funds earlier here. Are you concerned about the foreign capital?

Chairman Volcker. Well, you know Mr. Paul said we haven't got any savings here. Well, where is it? It's in Singapore; it's in China; it's in Abu Dhabi, and Dubai, and Kuwait, and we are in a position where we have to go to these countries and their sovereign wealth funds to recapitalize our financial system. Not a very happy circumstance, but we'll take it where we can get it, I guess for the moment, and that is the attitude of the financial institutions.

But we don't want to be in that position, and we've got to restore a kind of equilibrium where we are not in that position.

Senator Klobuchar. What role do you see the price of oil and our dependency on foreign oil, and our lack of developing our own energy policy, playing here?

Chairman Volcker. Well, you know, we're dependent. I'm afraid there's nothing we can do about it in the short run. And all this talk about energy independence is pie-in-the-sky for the moment. We are heavily dependent upon oil imports, which leaves us at the mercy of whatever squeeze there is in the market for economic reasons or other reasons.

Senator Klobuchar. But if we did develop a long-term policy like some other countries have done, do you think we could change that?

Chairman Volcker. Well, I am certainly in favor of developing both short- and long-term policies. I would be in favor of developing policies. But of course, there we are. That is a real nice issue for the Congress and for the next President—

Senator Klobuchar. Good. Thank you.

Mr. Volcker [continuing]. No question about it.

If I may just come back to something Mr. Paul said, which I think is relevant: How did this compare with the crisis in the late 1970s?

There the enemy, in my view, but I think in the country's view, was quite clear. There was an overpowering concern about inflation, and the country was ready to—it may not have been delighted, but there was a sort of acceptance of extraordinarily tough measures.

We also had a financial crisis in the midst of all that, but that financial crisis involved—was centered in the banking system. And a crisis that was centered in the regulated banking system was

frankly easier to deal with and contain than the present crisis, which is so diffused and involves big institutions not under the direct control of the Federal Reserve.

Senator Klobuchar. All right. Thank you very much.

Chairman Schumer [presiding]. And now, Representative Hinchey.

Representative Hinchey. Thank you very much, Mr. Chairman.

Chairman Volcker, thank you very much. I am a great admirer of yours, and I want to express my appreciation for everything that you have done publicly, and the work that you have done since you left the Federal Reserve as well, which has been very substantial. I very much appreciate your being here.

I think that what you mentioned about the leading by example I think is very, very important. The best way to lead is always by example. And of course the worst way to lead is by example. That is what we have seen recently, leading by example in some of the worst ways by creating this huge national debt, devaluing the dollar so substantially and sort of debilitating our circumstances domestically, particularly with regard to the average family—the average person and the average family.

The Consumer Federation of America, for example, has estimated recently that the average household now has about \$7,500 in credit card debt, and that the Government Accountability Office has said that the top six credit card issuers have charged recently \$1.2 billion each in penalty fees.

Now that was 2½ years ago, back in 2005. That is the latest—the last time we have the numbers. So that is about \$7.2 billion in penalty fees which were charged on credit cards to consumers around the country. And credit card debt is going up very, very substantially. And because credit card debt is going up, it is impacting on the spending of median-income people.

As we know, the Gross Domestic Product of this country, about ⅔ of it—more than ⅔ of it—is driven by the spending of median-income people, median-income households.

So these are the things, frankly, that concern me the most. One of the things that you dealt with was the issue of stagflation where you had a downturn economy and growing inflation, and I think we are in danger of seeing that come back.

So these are the things really that I believe we have to deal with here. We have to provide some regulation. One of the issues I think with regard to the banking company was—banking industry, rather—was the repeal of Glass-Steagall back in 1999, and the impact that that has had on the creation of things like these hedge funds and other forms of investment.

Now that was done intentionally. It was done purposefully by the Congress back in 1999, and I think it has had disastrous consequences.

So, I would appreciate it if maybe you could comment on those issues and perhaps give us some direction as to how we might proceed.

Chairman Volcker. You've raised some, obviously, very broad issues. My own feeling about the repeal of Glass-Steagall was that the formal repeal was probably catching up to the realities in the

marketplace. Because of technology, banks were able to do things they weren't traditionally able to do, and other institutions were able to do things the banks were doing, and it got increasingly hard in practice to separate the functions in many cases.

So in a way you can either glory in it or regret it, but it was probably inevitable that the old Glass-Steagall got eliminated. Whether it had to go all the way, you know, you can debate the details, but broadly I think it was inevitable, and you can't turn back the clock on it.

But some of the other comments you make, I think, are only specific reflections of the fact that this financial crisis is tied in with an underlying economic imbalance where we have been too dependent upon consumption supported by the kind of credit card debt you're talking about, and also the kind of mortgage debt that is in so much trouble in the market today. And somehow that has to change.

You could argue—I made a speech a few years ago saying this is going to have to change. It could change by policy, but I thought it would be very unlikely that policies would be changed because it involved things that people don't like, like raising taxes to reduce budget deficits and that sort of thing, and it is much more likely to change in response to a financial crisis.

Well that was a pretty good prediction. That's where we are, in a financial crisis that is forcing lower consumption, more restrained consumption, and I think will end up with increasing savings in the country. With the decline in the dollar increasing exports, we will make the underlying economic adjustments. But that's a kind of a rough ride while it's happening, and the whole effort is—I think whether people admit it or not—to have it happen, but try to avoid some of the more severe consequences of the financial crisis.

Let me say—just returning to the dollar and stagflation, and so forth—I think there is some resemblance of where we are now in the inflation picture to the early 1970s—not to the full-blown inflation of the later 1970s when you had an underlying tendency for inflation to increase, and then you had a big increase in oil prices; you also had a big increase in agricultural prices for a while. The price indices went up very sharply and while the extremes receded, I think the policy response was not forceful enough; the monetary policy response was not forceful enough in those years.

If we lose confidence in the ability and willingness of the Federal Reserve to deal with inflationary pressures and to sustain needed underlying confidence in the dollar, we will be in real trouble. And that has to be very much in the forefront of our thinking. If we lose that, we are back in the 1970s or worse.

Representative Hinchey. Well I wish this conversation could go on, but my time is up, and I thank you very much for those answers.

Chairman Schumer. Senator Webb.

Senator Webb. Thank you, Mr. Chairman.

Chairman Volcker, I appreciate your being here. Again, I feel like I'm a prisoner of the clock. You may feel otherwise having sat there for quite some time, but 5 minutes is a very small amount of time to be able to address these issues.

As a quick follow-on—I have a larger question to ask you; I have had a number of people who work in the financial sector and who do this for a living say to me that the present Consumer Price Index dramatically understates actual inflation, if you look at the components which hurts people on fixed incomes who rely on Cost of Living adjustments, but actually works to the advantage of people in the financial sector.

Is that a correct evaluation?

Chairman Volcker. Well I don't know whether it's correct or not. I must confess that in my old age, I'm like the little old lady I used to hear about some years ago who kept saying, when I was in the Federal Reserve, there's a lot more inflation than you're telling me in those figures.

[Laughter.]

Chairman Volcker. I'm now the little old lady, and I think there's a lot more inflation than those figures are telling me. But I think it is kind of strange—I'm not saying it's dishonest; it's the way we calculate the figure—that housing is a big part of the Consumer Price Index, and we had this great increase in housing prices, and the Housing Cost Index in the Consumer Price Index hardly moved at all.

You know, there are reasons for that. It is based upon a very small sample relative to home ownership in the United States of rents, and that's imputed to the whole thing. There were artificial reasons that rents were being held down.

And of course this idea of excluding food and energy prices on the basis of volatility, which is certainly understandable in the short run, but when the food and energy prices are running high, not for a couple of months and then dropping, but running high for years, it doesn't sound quite right. It doesn't feel quite right.

Senator Webb. Your speech at the Economic Club of New York on April the 8th was a true breath of fresh air, if I may say, and I had it sent to me by a number of people. I want to ask you a question that I think relates to the key concern that many, including myself, up here have about basic economic fairness in the United States.

You said at one point that there are cross-cutting bureaucratic and political concerns—political concerns at a high level regarding the proper use and allocation of Government power and the low level of embedded economic interests.

You said a little later, "It is equally compelling that a demonstrably fragile financial system that has produced unimaginable wealth for some, while repeatedly risking a cascading breakdown of the system as a whole, needs repair and reform."

Then later on you mentioned, "Perhaps most insidious of all in discouraging discipline has been pervasive compensation practices."

I have watched these numbers and spoken about them, the percentage of—or the multiplier of executive compensation versus the compensation for average workers in this country. It is off the charts from 20 years ago. It is off the charts from any other country. So it can't simply be the result of the globalization and internationalization of American industry.

Obviously, Government policies can protect existing aristocracies. They can actually help create aristocracies in some form. With this

vast migration of wealth to the very top in this country, while other people are struggling, to what extent could you attribute this undeniably vast migration of wealth to the very top to Government policies? And what would you suggest that we think about doing about it?

Chairman Volcker. It strikes me as an extremely difficult area, and I'm not, I guess, imaginative enough to know how the Government can effectively deal with it.

It is partly ingrained in what we were talking of earlier about the incentives to start taking risks in this new financial system. There is a big payoff from success in the short run, and not much penalty, financially, anyway, over time, if the risks go the other way, and how you deal with that basic imbalance. There are obviously things that can be done and should be done, in the realm of corporate governance and the responsibility of compensation committees.

They seem to be overwhelmed by the argument that if we don't do it for our executive, some other company will do it and steal our executive away.

And everybody—it's like the Lake Wobegone Syndrome; everybody wants to be in the top quintile. I don't know if it's a bill of goods, but it's been sold to business boards of directors in a way that, so far, has been unstoppable.

I think it reflects a weakness in corporate governance. I can say that, but how to correct it?

Senator Webb. It's one thing to take high risk and high reward, and we all appreciate that. In this country, we're built on it. But it's another thing to take a very, very reduced risk—

Chairman Volcker. Obviously, there are techniques, though, that people with stock options or otherwise could not claim the great rewards immediately, but have to wait and see how things evolve over a period of time before they can accept the rewards, and some of that's being built into current compensation practices, but I think, a little too slowly, and not rigorously enough.

Senator Webb. For instance, the margins that are allowed for investing in oil futures, which are very low, and as a result, have low risk. Senator Levin had a very revealing chart that he used on the Senate floor a few days ago, talking about the percentage of oil futures and options contracts that were speculative, compared to just 10 years ago.

I think the number has gone up 12 times, when you can buy in for 3 or 4 percent on a margin, causing a lot of people to say that the price of oil is overpriced by perhaps \$50.

Chairman Volcker. I know it's very hard to make judgments in that area. Speculators do serve some purpose in markets, but if it gets to be one-sided, I suppose that, fundamentally, going back to the earlier problem, people think they're going to be rescued on the down side, they're more inclined to take risks on the upside.

That's part of the problem we have. The statistic that often gets quoted is the number of credit default swaps outstanding. This is an instrument that hardly existed 5 years ago and the latest figure I have seen—and I don't know who counts this up—is \$60 trillion worth of credit default swaps which must be 5 or 6 times the total amount of credit outstanding.

How can you have more protection against defaults than if everything defaulted? It shows there's a lot of trading in the market that isn't directly the kind of basic insurance policy that the credit default swap is supposed to represent.

Senator Webb. Thank you for your testimony.

Chairman Schumer. Well, Chairman Volcker said he had to go at 11; since you're such a great person for us to ask questions of, I'm going to try to have a second round for people who want to ask a question or two, and I'll take the prerogative of the Chair.

First, I mean, your testimony is incredible, and basically it says that we're in a brave new world here, and we don't quite know what we're doing, and that's kind of frightening, and that's probably one of the reasons we had such worry.

I think that even the people who deal with these credit default issues, or trading or whatever else, sort of know that we're in this brave new world, and that's why you have a crisis of confidence in credit, which has been one of the big problems here.

But let me ask you two quick questions related to that. First, we were talking about how to restructure and your worry about having one regulator, would be that it would have too much power—I understand that—and not enough independence.

Parts of it—what about separating the central bank function from the overall regulatory function? Could the Fed be a good central banker, if it didn't have the regulatory ability to reach into these banks and other institutions and know what's going on, or have some degree of separation from that?

Chairman Volcker. Well, this is what you've got to struggle with, there's no doubt about it, but you can't completely separate them. In my view, you can't come close to completely separating them. That is what the United Kingdom did.

Now, they didn't do it completely because there was some liaison between the Bank of England, but suddenly they had a crisis in a secondary bank. This was not a major British bank; it was kind of something like a savings and loan.

Chairman Schumer. Yes.

Chairman Volcker. A sizable savings and loan. And the central bank suddenly felt it was faced with a crisis, in a sense, not of its making, and not of its observation.

Chairman Schumer. Right.

Chairman Volcker. And it reacted very strongly by saying—talk about unprecedented moves—well, on behalf of the Government—and that gets to your political question—they didn't do it on their own.

Chairman Schumer. Right.

Chairman Volcker. They said—I don't know if it was under orders or in consultation with the Chancellor of the Exchequer—we will guarantee the deposits, guarantee the creditors.

And what was really surprising then, is that the Chancellor of the Exchequer, not the central bank, said we will protect all the creditors of all the institutions in London for the time being if they are in a similar situation.

Now, I don't know quite what that means, but it was a very sweeping statement. And I feel quite certain that the central bank felt a little left out or a little abused, if I may say so, because it

didn't have a good handle on what should have been a relatively small problem with a savings type bank.

Chairman Schumer. It worked once, but it may not work again.

Chairman Volcker. That's right. And once you say that, I mean again, there is a moral hazard question. Once you say you're going to protect all the creditors in a crisis, they're going to expect you to do it the next time.

Chairman Schumer. Exactly.

Chairman Volcker. Look, you said there's some question about what the Congress can do. Let me make one appeal to you:

Don't push all this health of particular credit markets off on the Federal Reserve. I mean, it's very convenient not to provide assistance in the budget directly; it's very convenient not to do it by direct executive action and instead push it off on the Federal Reserve.

But that's the way to destroy the Federal Reserve in the long run, because it does need independence. So that's why I get a little concerned about, you know, Fannie Mae and Freddie Mac not playing their part.

But back in the Depression—or not just in the Depression, but in the late 1980s, early 1990s, the savings and loan crisis—you had a big problem in the mortgage problem. The Government set up a separate institution to deal with that.

Chairman Schumer. The RTC.

Chairman Volcker. They didn't tell the Federal Reserve to go out and buy all the savings and loans.

Chairman Schumer. That's a great point. One final question, and this is a more practical one. Recently, Treasury Secretary Paulson claimed the worst of the credit crisis is over. Chairman Bernanke, yesterday stated, "While the current situation is far from normal, turmoil in the financial markets has eased."

It has, obviously, temporarily. On the other hand, we have all the issues of complexity, opacity, new instruments, untested. Do you agree with their basic statement?

The worry, I guess, that everyone in the markets has is that another shoe will drop and then all hell will break loose.

Chairman Volcker. Let me say, first of all, even if we're over the worst of it and it gradually gets better, all the questions that you just raised are relevant, those on capacity and all the other things in supervision policy.

I think that when you look ahead, the outlook for the financial markets is going to be dependent upon the outlook for the economy. If the economy goes into a real recession, you could easily have another wave of defaults—you would, because that's the nature of it, and then all these strains and pressures would be reemphasized.

If the economy somehow moves along flatly for awhile, but then gradually improves, you've got a different picture. But you can't exclude the possibility that the economy is going to do worse, and that would have clear repercussions for the financial system.

Chairman Schumer. Congressman Brady, do you have any questions? Don't feel obligated, but if people have other questions—

Representative Brady. Yes, if I may, two quick questions, Mr. Chairman.

You expressed concern about the incentives on the top end from CEOs and managers dealing with risk. On the front end, with lenders, does securitization, in your view, adversely affect the incentives for lenders to screen those borrowers? In other words, if you're able to pass the hot potato on, clearly you're doing less due diligence at the outset.

Chairman Volcker. No question. And one of the approaches you could take—I guess I mentioned in my earlier speech, and I think it should be practical—is when you get these regulated lenders, the banks, potentially the investment banks, if you're going to package this stuff and sell it to other people, you better keep some yourself.

And so you're going to have to eat your own cooking, so to speak, at least to some degree.

And that might make a big difference. Banks would have to think about strengthening their credit departments again. So that's at least one approach.

Representative Brady. Second question, just on inflation. Because of your experience, you warned recently that we ought not to allow inflationary expectations to become embedded in prices once again.

What's your current assessment of the inflationary outlook? What variables do you look at in making that assessment?

Chairman Volcker. Look, I'm an inveterate worrier about inflation, so I see it all the time. Behind every silver cloud, there's a dark cloud of inflation.

This situation reminds me, as I said earlier, a bit about the early 1970s when we had an explosion in oil prices, an explosion in food prices, against a background of growing underlying inflation.

And it was not dealt with very forcefully because of the concern about the economy and it will go away and so forth. And I think that's a danger now.

So, I think the Federal Reserve needs all the reinforcement it can get, psychologically and otherwise to deal with inflation.

And the question about the price index, we have changed the price indexes in a way that for a given change in market prices, they show up less in the index. We are much more inclined to say there are improvements in quality, and therefore when the nominal price of say, an apple goes up, the apple orchard is better, we'll take account of the fact that a Fuji apple is crisper than a McIntosh or something.

Chairman Schumer. A New York State apple is crisper than a Washington State apple.

[Laughter.]

Chairman Volcker. My mother came from upstate New York and I spent Mother's Day driving through Wayne County to see the apple orchards. And there aren't many left in New York State.

Representative Brady. Beyond food and fuel, are there some variables you pay special attention to?

Chairman Volcker. Pardon me?

Representative Brady. Beyond food and fuel prices, are there other variables that you—

Chairman Volcker. Well, I think one of the danger points here which is beginning to be evident—only beginning—is that prices or tradeables have been held down. The prices of the kind of thing that the consumer buys a lot—clothing, household materials that we import en masse now from China and Asia—have either held steady or, in some cases, gone down for a decade. But now they're beginning to go up, I don't know how much is yet reflected in the stores, but it's reflected in the import prices because of the depreciation of the dollar and the growing inflation in China and elsewhere.

And so this is one point of concern. If the dollar got a lot weaker, that concern would increase.

But I think the bias here clearly is toward more inflation, offset now by the weakness of the domestic economy at the moment—flatness, at least, of the domestic economy.

Now, if the domestic economy began growing more rapidly, which you would like to see in time, then those inflationary pressures I'm referring to would become more overt.

So I think there is a problem, and we shouldn't be relaxed about it.

Representative Brady. Thank you, Chairman for your perspective.

Chairman Schumer. Vice Chair Maloney.

Vice Chair Maloney. In your testimony, you talked about financial engineering, and some universities are now having courses in financial engineering; yet engineering is a very precise science and financial engineering is not, and maybe we should not use this term. Your thoughts on that?

And also, I'd like comments on the fact that there is no entity that can evaluate the safety and soundness of investment banks now because they don't have to report the necessary data. There is no single source of data on the safety and soundness of all of our financial institutions, and without this information, the regulators are less able to take proactive steps that might avoid the need to resort to dramatic rescue efforts.

Could you elaborate a little more on the structure that we might look at in reorganizing and maintaining the independence of the Federal Reserve? What is the role of the SEC? Do you think we should create a new, consolidated, regulatory authority? If you could just expand a little more?

And then also, your statement—which was rather astonishing—that we now have \$60 trillion outstanding in so-called credit default swaps—

Chairman Volcker. For the world, not just for the United States.

Vice Chair Maloney. OK, for the world, but still, the idea that has been given to me by some of representatives of Wall Street is that the use of exchanges and clearinghouses for credit default swaps and derivatives, as a form of getting some type of control on what is happening, and the risk that is out there, again, again, we are deeply honored—

Chairman Volcker. The Chairman mentioned this initially, and I agree, that's an important area for work, and I think at least

some preliminary work is going on now within private markets themselves, and it's important for the reasons you suggest.

But I can't resist one comment about financial engineering, which is not my favorite subject. Given the problems in the financial system, on the one side, and given the problems with our infrastructure, on the other side, I think a strong case can be made that our universities are turning out too many financial engineers and too few civil engineers.

[Laughter.]

Chairman Volcker. And that imbalance ought to be corrected. The glamorous subject is financial engineering.

Chairman Schumer. It makes the most money.

Chairman Volcker. I have to tell you, when my oldest grandson told me he wanted to become a financial engineer, my heart sank.

[Laughter.]

Chairman Volcker. Anyway, on the question of consolidated regulatory agency, I think the issue is here. We're a big country; it's a big world; one consolidated financial regulatory agency is a very powerful instrument for good or for bad, and I actually would like to retain at least a little competition, if we could, between regulatory agencies, which is an argument for giving the Federal Reserve a good deal of authority, but somehow letting somebody else into the game, too.

That's a tough balancing act. We have too much of it now, I think, but how can we re-jigger that a bit?

And I think you'd have to have a certain consistency in regulation around the world. I don't think you have to have the same regulatory structure all over the world. Different countries will find different administrative arrangements suitable, and so I don't think that's a requirement, so long as you have some consistency in capital standards and liquidity standards and so forth.

Vice Chair Maloney. Do you think the Basel Accords will provide that?

Chairman Volcker. Well, the Basel Accords already—the old Basel Accords certainly have. That is a great—I'm a little bit prejudiced, but I think that was kind of a triumph of international regulation, because crude as it was—arbitrary as it was and we knew that—it did accomplish the purpose of getting international discipline on capital standards. I don't think there's any question that bank capital now is significantly higher than it would have been, without Basel I.

And if we hadn't had that, we really would be in a mess, because for all the pressures on the market, all the losses of commercial banks, they have by and large, stood—"firm" is the word that comes to mind, but maybe that's too strong a word—but the Federal Reserve did not have to rescue a commercial bank.

And that was partly because of those standards.

Chairman Schumer. It took 10 years; it took a long time. I worked with you on those, and it took a very long time to get everybody to agree.

Chairman Volcker. People said that was impossible, but it wasn't impossible. And now I think that's Basel II, and the problem with Basel II—and I'm out of touch—is that is very complicated, so that's not so transparent anymore.

Chairman Schumer. You're right. Last round of questions for Congressman Hinchey, and we'll be 5 minutes over the 11, if that's OK with you, Mr. Chairman.

Representative Hinchey. Thank you very much, Mr. Chairman.

Chairman Volcker, I can't help being somewhat pessimistic about the future of this economy, and I think that in part, that is because of the sort of laissez-faire attitude that the Fed has had with regard to the way in which the financial industry has been operating and the kind of manipulation that's been going on.

I mean, we see countless examples of that kind of manipulation, and we see examples of how that manipulation has had a direct impact on the economic circumstances of the average American family, and that's the part of it that worries me the most.

We've seen for example, as Senator Webb mentioned a few moments ago, how the rise in oil prices has been driven up, maybe as much as somewhere in the neighborhood of 25 percent by the manipulation of investments, falsification of investments, people not buying anything, but stipulating their investment and driving the price up, so that poor people have to pay more at the pump than they would.

That's just one example of the declining dollar and how we need to deal with that. All of these things need to be addressed.

There are the dire circumstances that the average family has now: Their consumer debt dramatically went up by \$15.3 billion back in March. It's now up by more than \$2.5 trillion. Now that's debt outside of household debt, mortgages, things of that nature.

Most of it is credit card debt. And the way in which the credit card companies are now manipulating this situation, pulling more and more money in, raising the interest rates and putting more penalties into effect in various sorts of ways is taking more and more money out of the hands of people who are struggling and using those credit cards for so many buying practices.

That's for food; that's for gas; that's for so many things that the credit card is being used, and that drives up the price that people are paying.

It seems to me that we're going to have to do something about this. And, as you say, I think the Fed doesn't have all the answers here, but the Fed does have some authority with regard to the way in which this manipulation is going on, and it hasn't really exercised that authority.

Fannie Mae and Freddie Mac are coming back with regard to housing now, but they're still not where they used to be, and they're coming back from a time when they got beat up after a lot of sort of negligence in the way that they were overseeing.

That, I think, has to be addressed, as well.

Chairman Volcker. Well, one of the implications of what you're saying is clearly a deficiency of the present system. Whether the Federal Reserve did rather poorly in supervision and getting after some of this manipulation, it is very difficult to do it, if you're just looking at banks.

But there's another set of big institutions out there that are not under your control, and the institutions you do have influence over,

will say, well, how can you do that to me when this guy I'm competing with every day doesn't have the same rules?

So that is another strong reason why this regulatory and supervisory tent has to be broadened.

Let me say in terms of manipulation, one thing that doesn't get much attention, but I think it's true, is these big financial institutions are now with or without Glass-Steagall; they are hotbeds of conflicts of interest.

One arm of the organization wants to create new mortgages and sell them to anybody, and do they sell them to their own investment management clients, or not? They're arranging a merger on the one side and financing or not financing participants on the other side.

I think there's a question—it won't solve the problem, but should these financial institutions, whether banks or investment banks, should they be running hedge funds at the same time? Should they be running equity funds at the same time?

They lead to direct collisions of conflicts of interest, and the bigger they get, the more complicated they get, the more systemic risk there is, so I think that's an area that deserves some looking at, too.

Representative Hinchey. Well, I think you're absolutely right, and I think that which we're experiencing right now flows from the repeal of Glass-Steagall, back in 1999. They wouldn't have been able to do those things; these hedge funds wouldn't be able to manipulate in the same way they're manipulating now.

Chairman Volcker. Well, the banks wouldn't have been able to do it, maybe, although the banks could have—you know, there's nothing in Glass-Steagall that said a bank couldn't have a hedge fund.

The Federal Reserve may have interpreted it that way, and I say that without thinking through all the law, but I think that's true. So it's a matter of interpretation. You can't blame it all on Glass-Steagall, but they have become widely diversified institutions and the diversification creates more conflicts of interest.

Representative Hinchey. One of the things you said earlier, was that what we're seeing now is the kind of thing that we saw in the early 1970s, the kind of situation that we're dealing with now.

And that tells me that if we don't deal with this set of circumstances, the situation is going to get increasingly worse.

And the main reason for that is the impact that it's had on median-income consumers, on the average household across the country. They find themselves in deeper and deeper debt, more dire circumstances, more trouble functioning on a daily basis, more trouble buying fuel for heating the home, or gasoline to get to work, or food, and a whole host of other things that, as you said, now are going up as a result of the situation in China and other places around the world.

Our economic circumstances are negatively impacting other countries in a very dire way. And all of that right now is influencing the median-income people.

We've got to deal with that. We've got to deal with that effectively, and if we fail to do so, I think that this edge of recession

that we're experiencing now is likely to get progressively worse and worse and worse over the course of the next several years.

Chairman Volcker. I don't know what to make of it, but the point you're making and the point Senator Webb made earlier about the distribution of income and the pressure on the median incomes or the lower incomes, all this bright new world of financial markets and financial engineering, maybe co-incidentally, has not been accompanied by much growth in real income for the lower half of the economy or the lower three quarters of the economy, really.

Chairman Schumer. Ninety percent.

Chairman Volcker. And I hesitate to say that' it's cause-and-effect, but it's an observation, anyway.

Chairman Schumer. Well, with that, Mr. Chairman, we thank you very much again for your erudition, your practicality, your ability to sort of synthesize issues and see both sides and then yet still have strong views. They have never ceased to impress, and we've missed you and even your cigar.

Chairman Volcker. Thank you very much.

Chairman Schumer. We're going to take a 5-minute break and then we'll get the second panel.

[Recess.]

Chairman Schumer. OK, we will resume.

We have lost our House colleagues because they have a vote. Some of them may be back. Let me introduce our panel who are very distinguished and we very much appreciate them all being here, and having a chance to listen to Chairman Volcker, which is a treat.

Dr. Douglas Elmendorf is a Senior Fellow at Brookings where he specializes in issues of macroeconomics and fiscal policy. Prior to joining Brookings, Dr. Elmendorf was an Assistant Director and Senior Economist at the Federal Reserve. He has also served as a Deputy Assistant Secretary in the U.S. Treasury Department, and as an economist on the Council of Economic Advisors. He holds a Ph.D. in economics from Harvard University.

Ellen Seidman is director of Financial—of the Financial Services and Education Project in the Asset Building Program of the New America Foundation. Ms. Seidman also serves as executive vice president in National Policy and Partnership Development at ShoreBank Corporation. From 1997 to 2001 she was the director of OTS. She was also Director of FDIC and chairman of the Board of the Neighborhood Reinvestment Corporation.

Alex Pollock is currently a resident fellow at the American Enterprise Institute where he's been since 2004 focusing on financial policy issues, including Government-sponsored enterprises, housing finance, and corporate finance. Before joining AEI, he spent 35 years in banking, including 12 years as president and chief executive of the Chicago office of the Federal Home Loan Bank.

With that, we are going to read your entire statements into the record. We would ask each witness to take 5 minutes and then we will go to questions. Thank you for being here.

STATEMENT OF DR. DOUGLAS W. ELMENDORF, SENIOR ECONOMIC FELLOW, BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. Elmendorf. Thank you, Mr. Chairman. I appreciate the opportunity.

The current financial crisis in the United States poses two separate challenges for economic policy.

One, to resolve the immediate problems; the other, to reduce the likelihood that these problems recur.

My testimony focuses on the latter challenge. The diagnosis and prescriptions I will offer come from a report I am writing with my Brookings colleagues Martin Baily and Bob Litan.

The U.S. financial system remains in a perilous state. I share the view of other observers and some people you have heard today that the worst of the credit crisis is probably behind us, but that is hardly certain. And even if it turns out to be right, the return to normal financial conditions will be slow and uneven. Billions of dollars of mortgage-related losses have yet to be declared by financial institutions, and risk spreads remain elevated.

Moreover, an absence of dramatic events does not imply that intermediation has returned to normal. Weakened bank balance sheets mean that banks will be reluctant to lend to households and businesses for some time to come.

Meanwhile, data on spending, employment, and production suggest that the economy is very likely in recession. The ongoing drop in housing construction, further predicted declines in house prices, tighter lending standards and terms, and rising oil prices are all exerting downward pressure on economic activity.

To be sure, not all the incoming data are bad and powerful economic stimuli have been sent in motion by the Federal Reserve Board and this Congress.

Therefore, I agree with the consensus of economic forecasters that a mild recession is the most likely outcome. But a more serious downturn is quite possible.

Thus, the experience of the past year vividly demonstrates the need for financial regulatory reform. Let me offer four principles to guide reform, and some specific recommendations that follow from them.

Principle number one is that financial regulation should try to keep pace with financial innovation. Innovation has been a positive force in our economy, as several people have said today, extending opportunities further down the income scale, improving the allocation of capital and distribution of risk, and helping to stabilize the economy.

Yet, innovation also creates problems. New products and institutions are usually more complex and less transparent. They generally boost leverage and risk-taking, and they tend to skirt existing regulation and supervision.

Financial innovators and regulators are in a race, and the regulators will lose. But it matters how much they lose by. If regulators do not try to keep up, or if regulators are completely outclassed in the race, much of the benefit of financial innovation will be offset by the cost.

Principle number two is that mortgage origination should have simpler disclosures for everyone, and some limits on offerings to subprime borrowers. Having more choices may not improve people's well-being, if they are choosing among complicated products without enough information and understanding.

Evidence demonstrates that people do not fully understand the financial arrangements. An innovation that offers more options can make that problem worse. Martin Baily and Bob Litan and I recommend simpler mortgage disclosures, in fact, taking something put together by one of my fellow witnesses this morning—pre-mortgage counseling for subprime borrowers, and perhaps a default mortgage contract from which people could opt out.

Also, further restrictions on the design of mortgage contracts under the HOEPA rules, and a broadening of HOEPA coverage along the lines proposed by the Federal Reserve. And Federal oversight of State regulation of mortgage originators.

Principle number three is that financial institutions and instruments should be more transparent. Self-interest is a powerful economic force, and smart regulation harnesses that force. By increasing transparency, we can give investors better tools to monitor financial risk-taking themselves.

The private sector is moving in this direction, and better regulation can help. We recommend for credit ratings agencies, greater clarity in presenting ratings across asset classes reporting of the rating agencies' track records, and disclosure of the limitations of ratings for newer instruments.

For commercial banks, clearer accounting of off-balancesheet activities. And for derivatives, a shift toward trading on exchanges which will encourage standardization of instruments.

Principle number four is that key financial institutions should be less leveraged and more liquid. As Chairman Volcker said, clearly more transparency is not enough. Even if private investors had perfect information, they would take greater financial risks than are optimal from society's perspective. The reason is simply that risk-taking has spillovers, in part because of contagion in the financial system, and in part because of the Government's safety net, including deposit insurance and the lender-of-last-resort role of the Fed.

To counteract this tendency toward excessive risk, we recommend for commercial banks capital requirements for off-balancesheet liabilities; required issuance of uninsured subordinated debt; and closer supervision of risk management. For investment banks, we recommend closer regulation and supervision. And for bond insurers, higher capital requirements and closer supervision of underwriting standards, especially for new and untested products.

Let me conclude by observing that financial markets will always experience swings between confidence and fear, between optimism and pessimism, but effective regulation and supervision can reduce the frequency, the magnitude, and the broader consequences of those swings.

Thank you, very much.

[The prepared statement of Dr. Elmendorf appears in the Submissions for the Record on page 58.]

Chairman Schumer. Thank you, Mr. Elmendorf.
Ms. Seidman.

STATEMENT OF ELLEN SEIDMAN, DIRECTOR, FINANCIAL SERVICES AND EDUCATION PROJECT, ASSET BUILDING PROGRAM, NEW AMERICA FOUNDATION, WASHINGTON, DC

Ms. Seidman. Thank you, Senator Schumer, and thank you for giving me the opportunity to testify before you concerning the regulatory implications of and guidance we can take from the current market failures.

As you have mentioned, I have had a variety of jobs and experiences recently, and all of them—my project at the New America Foundation, my work with ShoreBank, and my tenure as the director of the Office of Thrift Supervision and the seat on the Federal Deposit Insurance Corporation—all are what I draw on for many of the points and recommendations I make today.

Before I get to recommendations, I want to step back for a minute and consider how we got here. I think there are three root causes, and these can be stated in a number of ways: The unsustainable buildup of system risk; an antiquated, uneven, and frequently ineffective regulatory system; and a loss of alignment between serving customers well and standard business practices.

First, we have allowed systemic risk to build up to what has obviously become an intolerable level. The risks include those that were known, but hidden from consumers, from investors, from participants in the system, from regulators; risks that were unknown, often because firms had created such a degree of complexity that even the best efforts at ferreting out risks would have failed; and risks that were unknowable, the model failures that Chairman Volcker talked about in his Economic Club of New York speech.

Excessive leverage and reliance on short-term funding to support long-term assets exacerbated the impact of these risks.

Second, we have both tolerated and allowed to grow a regulatory structure that has two major failures. First, entities performing the same kinds of functions are regulated very differently, with the general effect that business practice has flowed downhill to the practices of the least regulated.

But second, we have not focused our regulatory attention tightly enough on what really matters. Is finding every last SAR violation really more important than making sure that the implied recourse on SIVs is adequately capitalized, or that borrowers have an ability to repay?

Our regulatory system has become simultaneously unduly complex, ineffective where it counts, and excessively burdensome on some of the least risky and most consumer-friendly elements of the system.

Now getting this balanced right is hard. In my tenure at OTS I know we sometimes got it right, as when we stepped in early to keep thrifts from funding payday lending; sometimes we got it wrong, most spectacularly in the Superior Bank failure; and sometimes we did things that seemed right at the time, but had in retrospect some unintended negative consequences, and I think these are the most difficult.

An example of this is the subprime guidance that all the regulators issued in 2001. Sure it helped keep the banks from getting in even more deeply than they did, but what it also did was push subprime lending outside of the banks, making our current problem worse.

But the fact that we sometimes get it wrong does not mean we are excused from trying.

Third, we have lost incentives for financial institutions to provide high quality, consumer-friendly products that provide long-term value. This is a result with many causes:

The originate-and-sell business model that especially when tied to the brokering at the front and CDOs at the back, has separated the interest of borrower and lender and of principal and agent.

Not extending the affirmative service mandate of CRA beyond banks and thrifts.

The manner in which CRA and other consumer protections were, or frequently were not, enforced.

Failure of financial literacy to keep up with the fast-paced fast-changing financial world, and not focusing our imagination and creativity on ways to help consumers gravitate to products and services that are beneficial to them while also profitable to providers.

Now this is not just being nice to consumers. As should be obvious from the mess we are in now, the financial viability of institutions is inextricably linked to that of their customers, including consumers.

So what do we need to do?

In the face of the problems that families, communities, companies, and markets now confront, I believe the critical question is how can we re-establish in our financial markets and the companies a long-term quality-oriented culture that incents all parties to focus their attention on products and services that benefit both sides; complete and accurate transparent risk assessment and management; and profitability and growth that is sustainable over the long run.

This is not a job solely for a regulatory system, and it is just as obviously not easy, but I think if we set it as a goal, we will have a standard to measure our thoughts and proposals against.

I suggest six critical strategies:

First, effective enforcement. The will and financial wherewithal to enforce laws and regulations we establish. Without this we are not only allowing bad things to grow, we are fooling ourselves into believing we have resolved problems. And this is an issue not only at the Federal level, but also at the State level where regulatory agencies are frequently starved for resources.

Second, risk assessment. Namely, concentration on enhanced risk knowledge and transparency within organizations, among organizations, for the public, and to and among regulators both domestically and internationally. We can no longer afford to have institutions that do not know their own level of risk and that of their counterparties and regulators who are also in the dark.

Third, capital adequacy, with increased capital all around. This has three critical effects. First, capital is the penultimate guard against institutional collapse. Second, because capital is at risk it serves to mitigate against excessive and foolhardy risk taking of

the heads-I-win/tails-you-lose variety. And third, if all entities in the system are required to hold a greater amount of capital, demand for returns based on financial leverage should diminish. And I think it is time to recognize that in an uncertain world, loan reserves are in practice part of the capital structure, and to allow them to serve a counter-cyclical function by building up during good times so they can be drawn down in the bad that will inevitably follow.

Fourth, enhanced responsibility. A system where all players have skin in the game. Realigning the interests of borrowers, lenders, and all those in the chain between money provided and money used. For institutions, in part it is capital. But an explicit continuing residual interest in sold assets whose value depends on future performance should also be considered. And certainly we need to do something about compensation systems, both individual and institutional that do not recognize back-end risk. In this connection, I urge Congress to move ahead with consideration of the two sets of bills related to the mortgage crisis that are pending, those dealing with the regulation of the market and those dealing with the response to the crisis for homeowners, communities, and markets.

Fifth, regulatory consistency across entities that are performing the same tasks, such as providing consumer credit or brokering significant financial services for consumers, and/or have access to the same kinds of benefits.

At the same time, we need to be cognizant of actual risk and relate it to actual burden. Regulation is a fixed and a hidden cost and smaller institutions both have fewer options for dealing effectively with regulators, and smaller budgets within which to absorb the costs.

Finally, aligning incentives with practices that treat customers fairly and equitably before, during, and after their purchase of financial services. There are many ways to do this, including not only consumer protection legislation and regulation, but also the establishment of a suitability standard for those selling or brokering significant consumer credit products; enhancing and making more broadly applicable the Community Reinvestment Act; public disclosure systems that extend beyond the Home Mortgage Disclosure Act to enable the public and the media to see who is being served, who is doing it well, and who is doing it badly; improving financial literacy; and barrier removals and incentives to help consumers do the right things, such as the opt-out provisions that were incorporated into the Pension Protection Act of 2006.

As markets begin to stabilize, or we reach what I suspect will be temporary lulls in foreclosures or house price declines, it will be easy to fall back into believing that the status quo is acceptable; that changing it is too hard; or that enhanced regulation of consumer products will hurt consumers by limiting choice.

Such a result would be not only dangerous and a mistake, but also a waste of the trauma and turmoil we have been through. We instead need to use this experience to learn, to think creatively, and to act.

Thank you, very much.

[The prepared statement of Ms. Seidman appears in the Submissions for the Record on page 63.]

Chairman Schumer. Thank you, Ms. Seidman.
Mr. Pollock.

**STATEMENT OF ALEX J. POLLOCK, RESIDENT FELLOW,
 AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC**

Mr. Pollock. Thank you, Mr. Chairman, and thank you for the chance to be here today.

Well, here we are, as we know, in the deflation of a classic asset bubble, this time of houses and condominiums. We keep having these financial adventures no matter how great our technological advance, our theoretical advance, or our regulatory reorganizations. We keep having them because the human nature behind the bubbles and busts doesn't change.

So the bust continues. Large losses of the housing bust are now being recognized in the general Main Street banking system. I think it is quite important in this context that 48 percent of the total loans of insured depositories are based on real estate and for the vast majority of banks—those which have assets of less than \$1 billion—67 percent of the loans are based on real estate.

From this, we know that a real estate bust is a serious matter for the old-fashioned banking system, just like it is for the new-fashioned banking system.

Now political actions also played a role in the housing bubble. Politicians of both parties cheered increasing home ownership rates and expanding so-called access to lower quality credit.

On top of this, bubbles are notoriously hard to control because so many people of all kinds make money from the bubble while it lasts, and everybody likes the bubble while it is still expanding. But of course, all bubbles come to a sad end, and I can't resist this story: Retreating eastward after the collapse of the bubble in Kansas land prices of the 1880s, financed by mortgage money from the East Coast, defaulted farm mortgage borrowers who had abandoned their farms to the lenders had the sign on their wagons: "In God we trusted, in Kansas we busted."

Today we can say: In house price appreciation we trusted, with house price depreciation we busted.

Some current discussions give the impression, Mr. Chairman, that there used to be a time when highly regulated banks dominated the credit system and so we didn't have any problems because we had all these regulated entities. This we could think of as the "old financial system."

Well, as the discussion of earlier this morning made clear, there never was such a time. There never was such a golden era of regulation.

In my written testimony I go through in some detail the severe credit crunches of the 1960s, the financial disasters of the 1970s, the giant bust of the 1980s, all of these taking place in the old financial system when all of the assets were on the balance sheets, of banks and thrifts.

The old financial system was also utterly opaque. Nobody knows less about the actual risk being undertaken than a depositor in a bank, at least a typical depositor.

So following the 1980s bust, the Secretary of the Treasury said about the reforms of 1989 and the early 1990s, they have the motto of "Never again." And those are the mottos of every reform, "Never again." Yet, Mr. Chairman, here we are again.

We even had the enormously expensive Sarbanes-Oxley Act to manage and limit corporate risk, and it was so successful we've nearly had a global financial collapse. And as Chairman Volcker said, we watched the consolidated British regulator, the FSA, separated from the Bank of England, be involved in great troubles trying to deal with the Northern Rock situation.

In sum, we have to be realistic about the limitations of all interventions. I am against utopian hopes for what financial regulation can achieve, but I am for sensible improvements.

My written testimony makes eight suggestions for such improvements, of which I will discuss the first three and the last one briefly.

First thank you very much, Dr. Elmendorf, for mentioning the one-page disclosure. I have previously testified to you and this Committee that we should have a clear, straightforward one-page disclosure.

And, Mr. Chairman, you introduced—and thank you very much—S. 2296—

Chairman Schumer. As a result of your testimony, Mr. Pollock.

Mr. Pollock. Thank you, sir—which would implement this idea. Everybody should be able to agree on this idea, and I certainly hope it will be included in any final mortgage legislation coming out of the Congress.

Second, we have the issue of rating agencies, which we all know are an issue. Rating agencies are, they say, in the business of publishing opinions about the future. I think they're right about this. One implication of that is of course, such opinions will inevitably prove to be mistaken some of the time, and even disastrously mistaken.

More opinions and more competition are likely to uncover new insights into credit risks and methods of analysis, and as many people have said, a particularly desirable form of this competition would be from rating agencies solely paid by investors.

But here is a larger question I would like to pose today.

Since all opinions about the future are liable to error, and opinions based on financial engineering and models—as we have learned to our sorrow—are liable to disastrous error, why should the U.S. Government want to enshrine certain opinions as having preferred, preferential, indeed mandatory status among others?

I think it should not. And I suggest that all regulatory requirements to use the ratings of certain preferred agencies should be eliminated.

Third is the topic of encouraging credit risk retention by mortgage originators. As some other speakers have touched on, I think this is a key idea.

One of the lessons of the savings and loan collapse was that for the depository institutions to keep long-term fixed-rate mortgages on their own balance sheet was extremely dangerous in terms of interest-rate risk.

You have to smile, Mr. Chairman, when you hear certain people say, well, those were the good old days. The savings and loans made the loan and kept it—as if they couldn't remember that by doing that, they put themselves out of business.

So the answer was to sell the loans to bond investors through securitization and divest the interest-rate risk to those better able to hold it.

As a side effect, not really intended, the credit risk was also divested. Well, now we've learned in the wake of the mortgage bubble and bust that it has problems of its own when you split the incentives of those making the credit decision and the ultimate investor which actually bears the credit risk.

So I think the right synthesis of the historical lessons is for securitization to continue to address interest-rate risk, while encouraging at the same time the retention of significant credit risk by the original mortgage lenders.

Now there are numerous regulatory and accounting obstacles to getting this done, but it seems to me that the obvious superiority of the structure makes it worthwhile to try to overcome them. I suggest that Congress ought to give, as an assignment to an appropriate group of financial regulators, figuring out how we could make the synthesis happen and remove the obstacles.

Finally, Mr. Chairman, as the great financial writer, Walter Bagehot said, "the mistakes of a sanguine manager are far more to be dreaded than the theft of a dishonest manager." In other words, nothing is more destructive than confidence and optimism. The best protection against excessively sanguine beliefs is the study of financial history with its many examples of how easy it is to be plausible but wrong, both as financial actors and as policy-makers. We all ought to be studying the recurring bubbles, busts, foibles, and disasters of financial history to gain perspective, and with luck, even wisdom.

Thank you for the chance to be here.

[The prepared statement of Mr. Pollock appears in the Submissions for the Record on page 65.]

Chairman Schumer. Well thank you. I want to thank all three of you. These were outstanding testimony, and I just hope—I would like all my colleagues to be able to see it as we begin to enter this brave new world. There is a brave new world out there in the financial markets, and now there is a brave new world in terms of regulation, because nobody says the present system works.

First a quick question for Mr. Elmendorf. You talked about false dawns we have already seen in the credit crisis. Can you elaborate? Where do you see other weaknesses that might creep up on us?

Dr. Elmendorf. The false dawns I mentioned are last October, and then again earlier this year when it appeared that conditions had stabilized—or were stabilizing.

Chairman Schumer. Right.

Dr. Elmendorf. Much as it does today. So I am hopeful, as I've said, that this is really the dawn. But I think the biggest risk is that there are losses out there that have not been declared.

We don't know how big the total losses in the world on mortgage-related securities will be. We don't know how much is held by U.S. institutions, but the best estimates I have seen suggest that there

are tens if not hundreds of billions of dollars of mortgage losses that have not been declared. And until they are declared, we don't know who bears them and who will suffer.

Chairman Schumer. So in the mortgage area itself, not a separate or not—

Dr. Elmendorf. That's right. Not only do we not know, but the other institutions who would do transactions with them don't know, and that uncertainty is what keeps the risk spreads high and creates other problems.

Chairman Schumer. I see. Mr. Pollock, just on credit rating agencies, which you touched on, as you know now, there are two companies that do get involved in—or use the model that you suggest, which is investor-rated.

You don't think that competition is enough now to spur things on?

Mr. Pollock. I think that competition is excellent, particularly to have the competition, as you and I have discussed before, between the models, between the issue-pay model and the investor-pay model, is a definite step forward.

As I suggested in my testimony, there is another step I would take.

Chairman Schumer. Which is just to get rid of the Government imprimatur—

Mr. Pollock. Yes.

Chairman Schumer. And let it rip. What do you folks think of that? Dr. Elmendorf, Ms. Seidman? Ms. Seidman, you've had the expertise in that area.

Ms. Seidman. Right. I must say that as we were working on what has become Basel II, and this question came up, front I was very uneasy about enshrining the rating agencies in the regulations concerning the capital system.

I think the problem that we face is the famous “compared to what?” problem. Because the response was always, well, if it's not the rating agencies, then you've got essentially two other potential players. One is the regulators themselves, which I think is the most desirable solution. But as we've discussed earlier today, given that the regulators are almost always behind the innovations, and in good times can never compete for sufficient talent, that is extraordinarily difficult.

And the other is the option that has in fact been enshrined in Basel II, which is to let the institutions themselves make the decisions.

So I think my preference would be strongly for a much more competitive, more broadly based transparency out of ratings agencies, but I am not sure that that is in fact the answer. I do know that what we've got now is very troublesome.

Chairman Schumer. Right.

Dr. Elmendorf

Dr. Elmendorf. I would just add two quick points.

I am also intrigued by the idea. I think one thing is we would need to be sure if that happens that people who take these ratings seriously understand that then they are dealing with a much larger set of raters with very different capacities perhaps. It is very important that they realize that that then puts them back on their

own judgment. It doesn't just proliferate the number of institutions getting a gold star that should be taken for granted.

Chairman Schumer. That's happening anyway.

Dr. Elmendorf. I think that is happening.

Chairman Schumer. They relied on these agencies to their detriment, and I am sure they are not going to rely as much now as they did a year ago.

Dr. Elmendorf. I think that's right.

I think the second thing is just to echo the importance of deciding how we are going to measure risk and control risk in these institutions, and what we do in the absence of the ratings.

Chairman Schumer. You didn't, Mr. Pollock, talk about the Super Fed idea, but you heard my interchange with Paul Volcker. Do you want to just comment on that? I mean, again I think having—Paul brings up two very good points. Too much power. And independence.

Both are important—well, why don't you comment. But on the other hand he agrees we have to do some degree of consolidation here.

Mr. Pollock. I did touch on what people are calling, and I called, the Super Fed in my written testimony—

Chairman Schumer. Yes, you did.

Mr. Pollock [continuing]. And that is the one thing in the Treasury Plan, Secretary Paulson's plan, that I think is likely to happen, as well being as a good idea.

Making bureaucratic agencies go out of existence, as we all know, is not easy. But I think if you look at the idea of an overall financial market risk overseer, that's actually pretty sensible. As I say in my written testimony, in my view it is consistent with the original idea of the Fed in 1913.

We didn't have Glass-Steagall in 1913, not for 20 more years.

Chairman Schumer. Right.

Mr. Pollock. And we don't have Glass-Steagall now. So the debates, which in my mind reflect the 1933–1999 period, which is over, really miss the point.

Then the next question becomes though, about oversight. Well then, how much information do you have to have? How much authority do you have to have? And you clearly have to have some.

On the other hand, I must say I am not at all drawn to the other part of the consolidated regulator idea. With consolidated regulators you have missed the checks and balances that Chairman Volcker talked about. Also, as we've seen with the rating agencies, you might get some things right, but you might get some things enormously wrong with a single point of view, and in general, I am a fan of checks and balances in every area of Government.

Chairman Schumer. Although a lot of the times now we don't have checks and balances, we just have sort of little islands each unto themselves, each issuing regulations. They're not checking one another.

First, they miss large chunks altogether. And then sometimes they send out conflicting and not necessarily one checking the other kind of thing. It is sort of a mismatch right now.

Mr. Pollock. It's a problem, but in my view, whatever we may design we would have a good Madisonian focus on ensuring checks and balances.

Chairman Schumer. Well, the American Enterprise Institute would very much like your reference to Madison. Any Hamiltonians here? Dr. Elmendorf?

[Laughter.]

Dr. Elmendorf. I am a Hamiltonian. I guess I would—

Chairman Schumer. From New York.

Dr. Elmendorf. Yes.

Mr. Pollock. That's what I was going to say.

[Laughter.]

Dr. Elmendorf. I think I would not put too much emphasis in thinking about regulatory reform on who is doing it. I think the higher priority is to focus on what the regulation is doing.

Chairman Schumer. Exactly, yes.

Dr. Elmendorf. So I think for example that the Treasury blueprint has a lot of interesting ideas, and I commend them for putting it out, but it focuses mostly on the boxes on the organization chart, which I think is a legacy of starting the study at a time when the biggest concern was competitiveness and consistency and not so much how to deal with the excessive leverage that we've seen.

I think it is better to focus on how we are regulating people. And many of the specific changes that all of us have talked about would be enhanced by some coordination across the regulatory agencies as exists.

It's not that I am an enthusiast for the current hodgepodge, but I think given the complexity of the issues, it is important to prioritize and tackle the issues that are highest priority first.

Chairman Schumer. Take my example of Bear Stearns, which I mentioned early on. That wasn't a question of having better regulation; it was a question of which box governed which. And you had the wrong box governing the wrong place. So that wasn't a question of coming up with a new way of regulating, or a new model.

My guess is—I don't know, but had the Fed had jurisdiction over Bear Stearns on safety and soundness issues, there's a real chance they would have forced them to do the things that the SEC was unable to, and certainly it wasn't even in their sphere of thinking.

Dr. Elmendorf. I think that's exactly right. The investment banks are a particular example where there is no box that is responsible for the aspects of their behavior that have turned out to be very important. And in that case, I do support—and we talk in our paper about giving more authority to the Federal Reserve.

If they are going to be lending to these institutions as the lender of last resort, they should be regulating and supervising them as well.

Chairman Schumer. Ms. Seidman.

Ms. Seidman. I basically agree with what Doug has said, but let me point out a couple of things that I think are important.

When we talk about the current crisis and the current market crisis, and focus in on Bear Stearns, I think we, very correctly, are thinking about the top tier of institutions.

And yet when we say “consolidated regulator,” all of a sudden we’re bringing into play insurance companies, community banks, pay-day lenders.

I totally agree with Doug, that figuring out what we’re doing is more important than figuring out the boxes.

Chairman Schumer. And you’d be sort of for functional regulation? You’d change the boxes to more conform—I mean, pay-day lender and somebody who’s looking at a hedge fund—

Ms. Seidman. Are very different.

Chairman Schumer [continuing]. For systemic risk—

Ms. Seidman. Are totally different.

Chairman Schumer. Are totally different and probably should be in the same agency.

Ms. Seidman. That’s my basic point; that I think that functionality at the level of institutions that can in fact create systemic problems, may not be the best way to organize.

It may be that with systemic-risk entities you organize across functions. Maybe this is where the Fed really should have its focus.

But that requires us to change our language.

Chairman Schumer. Yes.

Ms. Seidman. And to make sure that we don’t sweep all these other institutions that really still need to be considered under that.

One other thing I’d like to say about the British situation is I can remember visiting the FSA, while I was at OTS, and talking to them about how they were setting up. It was right after they started what they were doing.

And I’d say that there were two things that we need to be cognizant about with the British system: One, they rely very, very, very heavily on CPAs and the public accounting system in a way that is much greater than we do in terms of examination. They have a much smaller examination corps.

The second thing is that in England, name and shame still counts for something, and I’m not sure it does in the United States.

Chairman Schumer. So you might disagree with Volcker’s analysis that Northern Rock was a failure of the FSA and is much more a—well, go ahead. Do you?

Ms. Seidman. I mean, I don’t know what Northern Rock was primarily a failure of. I think that certainly, the issue of swooping in and announcing that you’re going to back up all the creditors is a troublesome way to run a system.

Chairman Schumer. That wasn’t the FSA.

Ms. Seidman. The FSA should have figured out that there was a problem earlier.

Chairman Schumer. Got it. Do you both agree?

Dr. Elmendorf. Yes.

Mr. Pollock. I think the problem, as I understand it—although I’m not a close student of it—in dealing with Black Rock—

Chairman Schumer. I’m sorry. I don’t want to create any problems.

Mr. Pollock [continuing]. With the Northern Rock—

[Laughter.]

Mr. Pollock [continuing]. Was the dependence on short-term market funding, funding longer-term assets. At least some people say the longer-term assets were of good quality. I don’t know.

There is a general characteristic of all financial bubbles, as the confidence builds. Here, I will cite a different authority, Hyman P. Minsky, an old friend of mine who wrote with great insight, I think, into the makings of financial busts which he called "financial fragility." As the confidence builds, it becomes viewed subjectively as normal and proper to engage in greater and greater degrees of short-term financing.

Chairman Schumer. Right. So that leads to something that I think has been touched on here, but I haven't heard much discussion of on this side of the table, which is your suggestion, Mr. Pollock, which I think either Dr. Elmendorf or Ms. Seidman talks about, which is encouraging risk retention by the mortgage originators.

It sounds great, but how the heck do you do it?

Ms. Seidman. Oh, I mean, we used to do it.

Chairman Schumer. OK, tell me.

Ms. Seidman. Even after securitization really got going, it was very traditional for the securitizer, the originating bank, to hold a significant piece of the bond.

Chairman Schumer. They were required to.

Ms. Seidman. Well, no one would take it from them is really what was going on, and the rating agencies required—it was a combination of no one would buy it from them and the rating agencies saying you've got to hold it in order to be able to get the kind of rating you want.

Chairman Schumer. And no one would buy it from them because, if they weren't holding a piece—got it. It wasn't that sophisticated where they were chopping up different types of pieces with different amounts of risk.

Ms. Seidman. This one is not as hard as people have a tendency to make it.

Mr. Pollock. Mr. Chairman, this one, financially speaking, is really easy. The problems are regulatory capital and accounting problems.

Chairman Schumer. I mean, yes, and what if you either required, or probably more likely, required different retention of capital by how much you retained. You know, different—

Ms. Seidman. Well, that's one of the big issues, because the question becomes, OK, so I've retained 5 percent of this pool. Have I therefore—

Chairman Schumer. Just 1 second. These days, the pool isn't uniform the way it used to be. It's chopped up in different pieces with different levels of risk.

Ms. Seidman. Right, but let's start with the simple one.

Chairman Schumer. OK.

Ms. Seidman. And even in the old days, the pools were always, for example, geographically diversified, except when they were CRA pools. They were geographically diversified because there was the benefit of geographical diversification, particularly in real estate.

So, if I'm holding onto 5 percent of the pool, the question is have I nevertheless held onto a 100 percent of the risk.

Chairman Schumer. Right.

Ms. Seidman. And if I've held onto a 100 percent of the risk, then proper capitalization should require me to capitalize it as if I'd held onto the whole pool.

Chairman Schumer. Right.

Ms. Seidman. And that obviously obviates the benefits of securitization.

Chairman Schumer. Right.

Ms. Seidman. That's why, as Alex points out, it's easy to figure out the finance; it's hard to figure out the capital and accounting.

Chairman Schumer. What do you think?

Dr. Elmendorf. I think this is a case where a private response can be very helpful. As Ellen says, people couldn't sell those before because the other side of the transaction wouldn't buy.

Chairman Schumer. Wouldn't buy.

Dr. Elmendorf. And I was on a panel recently with a former president of an important bank, and the president said that he thought the real problem was that people let Countrywide, which was the example, issue a bunch of mortgages they shouldn't have been allowed to issue. So I'm inclined to think that there should have been restrictions, mostly to protect the mortgage borrowers.

But the fair question I put to him was also, but you shouldn't have bought these mortgages from Countrywide. And if his bank had not been putting up the money, then Countrywide would not have been making loans of that sort, because they would not have been able to get the funding for them.

Chairman Schumer. Right.

Dr. Elmendorf. So, a lot of it comes back to these institutions, and this was a heavily regulated and supervised bank, but I think they need to take this lesson to heart. I think some of them have learned.

Also, I think the supervisors need to learn that if some bank is buying a lot of mortgages and they know nothing about the origination of those mortgages, or the underwriting standards that were applied, then they need to know doing this is very, very risky.

Chairman Schumer. We don't just have two levels here. It could be four or five levels, and that bank that bought them would probably, just like Countrywide, have no intention of keeping any of it even, right?

Dr. Elmendorf. That's right. I think some more——

Chairman Schumer. That doesn't——

Dr. Elmendorf. [continuing]. More askance the internal risk management systems and the more askance the supervisors need to look at it.

Chairman Schumer. Somehow, it seems to me, there's got to be a way to give both more information and more responsibility to the ultimate investor, as opposed to looking at it, as you go through the plan, I mean, which is sort of the opposite, in a certain sense, of what people are saying, although it relates to credit rating agencies, it relates to——

I mean, I guess you have two models here. They're not necessarily conflicting, but having the risk, having the ultimate investor have greater knowledge and ability to assess the risk—or maybe that's just a market force—or having the originator have some of the risk, based on, you know, based on credit.

Mr. Pollock. Mr. Chairman, could I add something?

Chairman Schumer. Yes.

Mr. Pollock. One of the key things in this idea of retention of credit risk by the originator is to distinguish between kinds of risks.

Chairman Schumer. Yes.

Mr. Pollock. You might—

Chairman Schumer. As opposed to—yeah.

Mr. Pollock. That is to say, you could be retaining credit risk, but fully, or at least very largely, divesting yourself of the interest rate risk and the liquidity risk, and that's where I think, Ellen, the rules have to adjust themselves.

For prime mortgages, most of the risk is interest rate risk.

Chairman Schumer. Yes.

Mr. Pollock. And that's where I think we could really do some fruitful work on distinguishing the types of risk and allowing this structure to emerge.

And also, as you say, Mr. Chairman, we don't want the buyers to be able to go to their trustees and say, nothing to worry about, I've got a Government-approved triple-A. You want them to say, wait a minute, what is this?

Ms. Seidman. This is another place where—and Alex mentioned it a little bit in his testimony—where I think we have to be careful about our language because thinking that the ultimate investor, me buying a share in a mutual fund, wouldn't be able to have any idea of risk, is—I mean, we'd be fooling ourselves. That's why we have deposit insurance.

Chairman Schumer. Well, in these instruments, you didn't have—

Ms. Seidman. I understand.

Chairman Schumer. The answer there would be that's why we have credit rating agencies.

Ms. Seidman. No, I understand, Alex's point was that there's nothing as opaque as a bank.

Chairman Schumer. Right.

Ms. Seidman. But we have deposit insurance, so we can put a deposit in. I do think that it is with the large intermediaries that eventually enable the little guys to buy, where we have to put this responsibility for knowing what you're buying and not buying it, if it's risky, and having your regulator tell you not to buy it, or that you have to capitalize heavily against it, if you have.

I think you just have to get the level right.

Chairman Schumer. A lot of people—and tell me if I'm wrong here—a lot of the people who ultimately bought this, were not little guys. They were very big guys.

Ms. Seidman. A lot of people were very big guys, but you know, there's the apocryphal—

Chairman Schumer. I'll bet the vast bulk of all of these chopped up pieces ended up not in—I mean, the only way they'd end up in the little guy's pockets was through pension funds and whatever else.

Ms. Seidman. That's exactly my point, right.

Chairman Schumer. But not—the actual purchaser who ultimately parked the stuff, was not a little guy.

Ms. Seidman. Right. There are pieces of information that simply weren't there. So, for example, on the first round of a securitization of mortgages, if you are a Lou Ranieri, you can get the information and run it through your computers.

Even Lou Ranieri could not do that through their CDOs because the information was not available.

Chairman Schumer. Right. But he, Lou Ranieri, fact in point, was a friend of mine, and he was warning about this stuff long before anybody else.

Ms. Seidman. He absolutely was. If people had paid attention to what Lou was saying in early 2006, we might be in a different place.

Chairman Schumer. Right. Dr. Elmendorf, you get the last word here on all this.

Dr. Elmendorf. That's a lot. I would just make a small point, which is that I think the extent to which these risky assets found their way back onto the balance sheets, or right next to the balance sheets of the large institutions, was one of the very surprising features for many people.

The idea had been that the risk was going to be disseminated, and certainly some was sent around the world. That's why UBS was in trouble and other foreign institutions.

But the fact that such a large share ended up right back on the balance sheets or in the structured investment vehicles that we pretended weren't on the balance sheets of these large financial institutions was shocking, and that's really—

Chairman Schumer. And they relied on the credit rating. I mean, I guess they ultimately—these very sophisticated institutions—I was not there. I don't do this for a living, but I'm sure somebody said, well, it's triple-A.

Dr. Elmendorf. Yes.

Chairman Schumer. And we can leverage it, and we can make a lot of money on a triple-A investment.

Dr. Elmendorf. I think that the extent to which the risk was correlated across the underlying mortgages was not recognized. There was a sense that you have a pool of a hundred thousand mortgages, then you can guess pretty well what share of the people will lose their jobs or get sick—

Chairman Schumer. Right.

Dr. Elmendorf. [continuing]. Or have other reasons for not paying. The extent to which the whole pool and all of the mortgages were only good if house prices continued to go up and didn't go down—which was a very highly correlated risk across them—was not understood, and it's hard to see, in retrospect, how that could have been missed, but it does seem to have been missed.

Chairman Schumer. I'm still totally befuddled by the fact that all these sophisticated people from the credit—would buy no-doc loans, and it's only no-doc loans—no-doc loans. And a lot of these—and it's only related to the, I guess, idea that everything will always go up and all you have to do, Mr. Pollock, is study financial history. Everything doesn't always go up, but that's what they were doing.

Dr. Elmendorf. Yes.

Chairman Schumer. Hey, this was great. Thank you all very much for your concern and erudition. The hearing is finished.
[Whereupon, at 12:04 p.m., the hearing was adjourned.]

Submissions for the Record



JOINT ECONOMIC COMMITTEE
 SENATOR CHARLES E. SCHUMER, CHAIRMAN
 REPRESENTATIVE CAROLYN B. MALONEY, VICE CHAIR



PREPARED STATEMENT OF SENATOR CHARLES E. SCHUMER, CHAIRMAN

I want to thank you, Chairman Volcker, as well the other witnesses who will join us on the second panel, for coming to this hearing today about the financial system, and the steps we need to take to reform our regulatory structures.

I'm worried that, because things do not seem as bad as they were a month or so ago, we're already starting to become complacent about the critical need to address the regulatory and market failures that have had much to do with the troubling economic situation we find ourselves in.

The past year has been a stark reminder of the direct link between Wall Street and Main Street, between the health of the financial markets and the economic well-being of all Americans.

A year ago, most of us had never heard of CDO's and CMG's and SIV's, of option ARM's and credit default swaps and auction rate securities. Now, we know that those who knew about these complex financial instruments clearly didn't know enough to protect consumers, investors, and our economy from them. And we've learned too much about the central role these financial tools have played in the worst housing crisis since the Great Depression, the freezing of credit markets worldwide, and the onset of our current recession.

Financial innovation is vital, both for the health of our financial system and our economy, but it is just as vital that financial regulation keep up with innovation. It has not.

In my view, this credit crisis is as much a failure of regulation as it is a failure of the marketplace. The goal of regulation should always be to encourage entrepreneurial vigor while ensuring the health of the financial system. We found that balance in the past, but it seems to have been lost. We have a 21st century *global* financial system, but a 20th century national set of financial regulations. That needs to change soon.

To begin, we need to acknowledge that consolidation has transformed the financial industry. We no longer have the clear distinctions between commercial banks, investment banks, broker-dealers and insurers that we did sixty years ago, or even twenty years ago. Instead, there are a large number of financial institutions surrounded by many smaller institutions—such as hedge funds and private equity funds—with their own specialties. It's as though we have a handful of large financial Jupiters that are becoming more and more similar encircled by numerous small asteroids. Our regulatory structure has to recognize that change. As large investment banks have come to act more and more like commercial banks—especially now that they can borrow from the Fed's discount window—then they need to be supervised more strictly.

We need to think very seriously about moving toward more unified regulation, if not a single regulator. We have too many regulators, each watching a different part of the financial system, while no one keeps an eye on the greater threats of systemic risk. In the U.K., they have a single, strong regulator who has responsibility for the entire system and the authority to act when necessary. Maybe a regulator with that authority could have prevented a debacle like the collapse of Bear Stearns by acting quickly and forcefully before things began to unravel.

We must figure out how to regulate the currently unregulated parts of financial markets. *For example, credit default swaps are a multi-trillion dollar industry almost completely outside the purview of regulators.* Recently, there's has been talk about creating a clearinghouse for credit default swaps. I think this an excellent idea, and the sort of innovation we should be thinking about more broadly. I also believe we need to think about whether a unique exchange for these swaps might be an even more effective way to bring about greater transparency and limit systemic risk.

We must have greater transparency in the financial system. The credit crunch has been as much a crisis of confidence as it has been a real economic crisis. Financial markets operate on trust, on the belief participants have that they can rely on the people they are entering into contracts with. As long as so many black holes remain in the financial system, it will be hard for that trust to be restored.

We must involve our international partners. National regulations can only achieve so much in a global financial market. It does us no good to enact new rules if other countries remain lax in their regulations or their enforcement. *The global financial regulatory system should not be the arithmetical equivalent of the lowest common denominator.* This crisis and the complexity of our system requires much more.

And finally, we must put aside the 'laissez-faire', no Government is good government, mantra that we hear from this administration and the other side of the aisle. The market does not solve all problems by itself and neither does the Government. That's why we need firm, forward looking regulation, to prevent the sort of crises we're facing now from recurring in the future.

I share with Treasury Secretary Paulson and Chairman Bernanke the hope that the worst of the credit crisis is behind us. But I am not convinced that it is over. *Whatever calm has been brought to financial markets today has been the result largely of extraordinary actions taken by the Federal Reserve.* Chairman Bernanke deserves credit, but the actions he has had to take are sign of just how unprecedented, and how troubling, this credit crisis has been.

We cannot sit back, relax and hope for the best. The American people, our economy and the global financial system cannot afford it.



JOINT ECONOMIC COMMITTEE
 SENATOR CHARLES E. SCHUMER, CHAIRMAN
 REPRESENTATIVE CAROLYN B. MALONEY, VICE CHAIR



PREPARED STATEMENT OF REPRESENTATIVE CAROLYN B. MALONEY, VICE CHAIR

Good morning. I would like to thank Chairman Schumer for holding this hearing to examine the risks in the U.S. financial system and potential solutions. I want to welcome former Chairman Volcker and our other witnesses and thank you all for your testimony today.

At the core of the ongoing liquidity crisis is the decline in home prices, which is causing banks to readjust their balance sheets and to buildup capital. Congress is currently focusing its attention on keeping families in their homes and stemming the deepening decline in home prices.

The crisis in the housing market has brought to light the inability of our most sophisticated and respected institutions to measure their exposure to opaque assets and manage the risks associated with them. Detangling the DNA of assets has become increasingly difficult for investors. We clearly need greater transparency for complex investment products to assure smoothly functioning markets.

Our entire regulatory system is also in serious need of renovation because financial innovation has surpassed our ability to protect consumers and hold institutions accountable. In our rather fragmented system, financial regulators do not have authority to broadly address systemic risk.

The Financial Services Committee will soon turn its attention to rethinking financial services regulation. Meanwhile, the Treasury Secretary has a sweeping proposal for revising the Federal regulation of all financial institutions. That plan would grant the Federal Reserve power to serve as an overarching "market stability" regulator, with the ability to collect information and require corrective action across the broad spectrum of financial services.

Our current system of multiple regulators leaves big holes that a "super regulator" could plug. For example, the unwillingness up to this point of the Federal Reserve and the S.E.C. to require working capital limits has been criticized as exacerbating risk-taking. Only now has the S.E.C. joined other Federal regulators in working with the Basel Committee to extend the capital adequacy standards to deal explicitly with liquidity risk.

The Bear Stearns rescue also exposed the lack of Federal regulatory authority to supervise investment bank holding companies with bank affiliates, as the Fed supervises commercial bank holding companies. Thus, investment bank holding companies don't have to maintain liquidity on a consolidated basis.

In the wake of the Bear Stearns debacle, S.E.C. Chairman Cox has said that investment banks can no longer operate outside on a statutory consolidated supervision regime. Giving investment banks access to the Fed's discount window, which was created for depository institutions, creates problems since they are not regulated like depository institutions. In particular, they have no restrictions on how highly leveraged they can be.

We need reform, but the Treasury plan is so sweeping that it risks being disruptive while we are working hard to stabilize our economy. Moreover, it risks eliminating regulatory voices that should be heard. The American system of Government relies on checks and balances, and we can all think of instances when the lone voice of the multiple Federal regulators has pushed the group to an action that was unpopular but proved to be right.

We should focus first on targeted reforms with maximum effect. Improving the transparency and accountability of trading in credit default swaps and derivatives is an example. A key factor that apparently pushed the Fed to rescue Bear Stearns was concerns about a domino effect from the interlocking relationships between thousands of investors and banks over credit default swaps, which are presently traded by investment banks off any exchange and without any transparency. Requiring the use of exchanges and clearing houses for credit default swaps and derivatives is worth exploring.

Mr. Chairman, thank you for holding this hearing and I look forward to our witnesses views on correcting the imbalances in our financial markets.

JOINT ECONOMIC COMMITTEE
SENATE REPUBLICANS

SENATOR SAM BROWNBACK, SENIOR REPUBLICAN SENATOR

PREPARED STATEMENT OF SENATOR SAM BROWNBACK

Thank you Mr. Chairman. I appreciate you scheduling today's hearing. Our topic is quite broad, Mr. Chairman. "Is the Credit Crisis Over and What Can the Federal Government Do to Prevent Unnecessary Systemic Risk in the Future?" sounds suitable for a series of well-planned and broad-based hearings. I certainly hope that we will take the time as a committee to examine this subject in much more detail.

Obviously, much of the current economic slowdown can be attributed to dysfunctional financial markets over the past year caused by turmoil in markets for asset-backed debt securities and obligations. We have witnessed the collapse of a major investment banking firm—or near collapse, but for the unprecedented action of the Federal Reserve Board. While there has been general praise for the actions of the Federal Reserve, questions have been raised about how close to or how far outside the boundaries of its authority the Federal Reserve actions were.

Mr. Chairman, I must say that one aspect of our hearing title causes me some concern—"prevent unnecessary systemic risk." I think we need to determine what level of systemic risk is acceptable before we can even venture into a discussion of whether it's necessary or not. I also believe that a related issue to define and sort out is the definition of the "lender of last resort" function of the Federal Reserve and what that actually means the Fed can and cannot do in pursuing that function.

I would like to note that the Fed took onto its balance sheet, and therefore the taxpayers' balance sheet, risky private-sector assets, inherited from an investment bank over which the Fed did not have direct regulatory oversight, in its part of the takeover of Bear Stearns by JPMorgan Chase. While the Fed has the power to do so, under a 1932 provision of the Federal Reserve Act allowing the Fed to lend to non-banks under "unusual and exigent circumstances," it isn't entirely clear what constitutes such circumstances. The Fed's recent actions introduce serious issues of moral hazard by signaling to risk-takers in financial markets that if the dice do not turn up favorable, the Fed and, hence, taxpayers will provide a backstop.

The Federal Reserve has also created new ways of lending to depository institutions and to investment banks by setting up a new Term Auction Facility and Term Securities Lending Facility. The latter allows primary dealers to exchange less-liquid securities at an auction-determined fee for some of the Fed's Treasury securities. Recently, the Fed has allowed private-sector asset-backed securities as securities eligible for such transactions. So, the Fed has basically been conducting some of its monetary policy by rearranging its, and therefore the taxpayers', balance sheet—trading Treasury securities for securities that include risky asset-backed private securities.

While I believe that the Fed's recent activities have been creative and may have helped reduce tensions in domestic and global credit markets, I also take seriously the responsibility that Congress has in its oversight role regarding the Fed. I think that we need to know more than we currently do about recent actions. For example, to my knowledge, we don't have a clear accounting of the assets or that the Fed took onto its balance sheet in the Bear Stearns-JPMorgan Chase deal or an accounting of the value of those assets. Given the Fed's recent emphasis on transparency, it would be useful to know, but interesting that we don't.

One of our witnesses today, former Federal Reserve Board Chairman Paul Volcker, is eminently qualified to offer perspectives not only on the broad topic of avoiding systemic risk, but on the more narrow question of whether or not the Federal Reserve acted appropriately.

Chairman Volcker served our nation at another time of crisis when the Federal Reserve's dual mandate was severely strained. Inflation raged in double digits and the unemployment rate was a full percent higher than it is today. Through Chairman Volcker's leadership, inflation was brought under control. That did not come without a steep price in terms of a recession that saw the unemployment rate rise to 10.8 percent.

It was also during his tenure that the Federal Reserve, over Chairman Volcker's objection, used its regulatory powers to grant banks expanded powers in the investment banking arena despite the provisions of the Glass-Steagall Act. It may be a useful time to revisit that decision and debate whether we need a clearer, Glass-

Steagall-like delineation between where investors have a safety net under them, subject to certain restrictions, and where investors should not expect any Government backing of their private risk taking.

It may be that part of our recent problem stems from an absence of such a clear delineation, because if you are a big enough private financial risk taker, and are intertwined enough with a large number of counterparties in important markets, then you evidently have access to the Fed's discount window and a taxpayer-funded safety net. Taxpayers are being exposed to risks without, perhaps, the benefit of adequate oversight regarding institutions that are being backed by the Fed. I am concerned that recent actions by the Fed could introduce too much moral hazard and signals that have been sent by recent Federal Reserve actions.

Before closing, I would like to take exception to the portrayal by many on the other side of the aisle of a recent financial crisis somehow caused by an Administration that is somehow antagonistic toward financial regulation and an Administration that shuns regulation of financial activity. I would ask: What actions identify such an attitude by the Administration? We clearly have now, and have had for some time, regulations against much of the freewheeling mortgage activities that led us to a lot of our recent problems. And a lot of those regulations are housed at the Federal Reserve, under the Home Ownership Equity Protection Act of 1994 for example. The current Administration did nothing to prevent the Fed from using its supervision and regulation staff to take action regarding what was clear to anyone with a pulse was risky mortgage lending in recent years. Nor did the Administration encourage any regulatory agency to act loosely in enforcing existing regulations. To paint the recent strains in mortgage and financial markets as somehow being caused by the Administration is plain and simply an exercise in groundless political positioning.

I am interested to hear Chairman Volcker's views and those of our other witnesses, on our present situation, changes to our regulatory system, and what other actions we should take to avoid another crisis within the next decade.

PREPARED STATEMENT OF HON. PAUL A. VOLCKER, FORMER CHAIRMAN OF THE
FEDERAL RESERVE BOARD OF GOVERNORS, WASHINGTON, DC

I appreciate the opportunity to discuss informally some implications of the systemic risks in the financial system as revealed in the current crisis. This statement will simply point out some of the more important and unresolved issues as I see them. The complications are evident. There are no quick and facile answers. Your deliberations can, however, help lay the groundwork for legislation that will, I believe, be necessary, if not now in the midst of crisis and an election campaign, then in 2009.

The background for the crisis and for any official and legislative response is the rather profound change in the locus and nature of financial intermediation over the past couple of decades. We have moved from a heavily regulated and protected commercial bank dominated world to a more open market system, with individual credits packaged and repackaged and traded in impersonal markets. Large commercial banks have themselves taken on important characteristics of investment banks, but the investment banks and hedge funds that have come to dominate the trading, if regulated at all, have not been closely supervised with respect to their safety and soundness.

The new "system" has, indeed, been heavily "engineered", with highly talented, well paid, and mathematically sophisticated individuals dissecting and combining credits in a manner designed to diffuse risk and to encourage an allocation of those risks to those most able to handle them.

The result in practice has been enormous complexity, and with the complexity has come an opaqueness. In the process, close examination of particular credits with respect to risk has too often been lost; the sub-prime mortgage is only the leading case at point.

The complexity has also made it more difficult to assess risk for the managers of particular large institutions, for supervisors and for credit rating agencies alike. The new system seemed to work effectively in fair financial weather, with great confidence in its efficiency and presumed benefits. However, I believe there is no escape from the conclusion that, faced with the kind of recurrent strains and pressures typical of free financial markets, the new system has failed the test of maintaining reasonable stability and fluidity.

One broad lesson, it seems to me, is the limitations of financial engineering, involving presumably sophisticated modeling of past market behavior and probabilities of default. It's not simply a matter of inexperience or technical failures in

data selection or the choice of relevant time periods for analysis. The underlying problem, I believe, is that mathematic modeling, imbued with the concept of normal frequency distributions found in physical phenomena, cannot easily take account of the human element of markets—the episodes of contagious “irrational exuberance” or conversely “unreasoned despair” that characterize extreme financial disturbance.

It is recognition of those extreme and unsettling market disturbances that conceptually has justified official intervention in free markets. That intervention has taken the form of regulation and supervision and of providing an official “safety net” for systemically important institutions, in the past almost entirely limited to commercial banks and traditional thrift institutions.

Faced with the evident threat of a potential cascading breakdown of an already heavily strained financial institution, the Federal Reserve, drawing upon long dormant emergency powers, recently felt it necessary to extend that safety net, first by providing direct support for one important investment bank experiencing a devastating run, and then potentially extending such support to other investment banks that appeared vulnerable speculative attack.

Whatever claims might be made about the uniqueness of current circumstances, it seems inevitable that the nature of the Fed’s response will be taken into account and be anticipated, by officials and market participants alike, in similar future circumstances. Hence, the natural corollary is that systemically important investment banking institutions should be regulated and supervised along at least the basic lines appropriate for commercial banks that they closely resemble in key respects.

Several issues now need to be resolved by legislation or otherwise.

Just how far should the logic of regulation and supervision be extended? To all “investment banks” and what is an accepted definition of an investment bank? What about to “hedge funds” of which I am told there are some fifty thousand around the world? Presumably very few of them could reasonably meet the test of systemic importance. However, a few years ago, a single large, widely admired, heavily “engineered” hedge fund suddenly came under market pressure and was judged to require assistance by the Federal Reserve in the form, not of overt official financial assistance, but of moral suasion among its creditors.

Recent events raise another significant question for central banking. Given the strong pressures and the immobility of the mortgage markets—pressures spreading well beyond the sub-prime sector—central banks in the United States and elsewhere have directly or indirectly intervened in a large scale in those markets. That approach departs from time-honored central bank practices of limiting lending or direct purchases of securities to Government obligations or to strong highly rated commercial loans. Apart from any consequent risk of loss, intervention in a broad range of credit market instruments may imply official support for a particular sector of the market or of the economy. Questions of appropriate public policy may in turn be raised, going beyond the usual remit of central banks, which are typically provided a high degree of insulation from political pressures.

That independence is integral to the central responsibility of the Federal Reserve (and other central banks) for the conduct of monetary policy.

The Federal Reserve also has in practice, and enshrined in its founding mandate, certain responsibilities for commercial banking supervision. In practice, it has in my mind been properly considered as “*primus inter pares*” among the various financial regulators.

In my view, a continuing strong role in banking regulation and supervision by the Fed has been important for at least three reasons. First, as the “lender of last resort” and the ultimate provider of financial liquidity, if should be intimately aware of conditions in the banking system generally and of particular institutions within it, a precondition for decisions with respect to financial or other assistance.

Second, the widely understood and accepted independence of the central bank provides strong protection from the narrow political pressures that may be brought to bear in the exercise of regulatory responsibilities.

Third, the broad responsibilities of the Federal Reserve to encourage orderly growth seem to me to encourage an even-handedness over time in its approach toward regulation.

I have long thought the Federal Reserve lead role in banking (and financial) supervision should be recognized more clearly than in present law. Experience over time, reinforced by recent events, also strongly suggests that if that Federal Reserve role is to be maintained and strengthened, important changes will be necessary in its internal organization. Specifically, direct and clear administrative responsibility should lie with a senior official, designated by law. Stronger staff resources, adequately compensated, will be necessary.

I recognize that, if supervisory and regulatory responsibilities are to extend well beyond the world of commercial banking and its holding companies, then a more

fundamental question will need to be faced. Should such a large responsibility be vested in a single organization, and should that organization reasonably be in the Federal Reserve without risking dilution of its independence and central bank monetary responsibilities?

Clearly, other large questions are exposed by the present financial crisis. The role and organization of credit rating agencies, the use and mis-use of mark-to-market and "fair value" accounting, the oversight of hedge funds, and somewhat removed but nonetheless important, the growing role of sovereign wealth funds, all need consideration.

More generally, I must emphasize that little of the needed changes and reforms can proceed independently, without consideration of, and a high degree of cooperation with, other leading financial powers, especially the European Union and Japan. In a world of globalized finance, recent experience demonstrates we are all in this together. Idiosyncratic national approaches simply cannot be fully effective, and can easily be counter-productive of needed discipline.

Recent years have brought encouraging progress in a number of important areas: bank capital requirements, common accounting standards, growing consistency in auditing and settlement procedures and elsewhere. It is those areas of intergovernmental, private, and public-private initiative upon which we need to build. The critical pressures on our financial markets are not unique; nor can an approach to dealing with those pressures be successful in isolation. We have a lot upon which to build, and we should not miss the opportunity to extend the areas of cooperation.

PREPARED STATEMENT OF DR. DOUGLAS W. ELMENDORF, SENIOR FELLOW,
BROOKINGS INSTITUTION, WASHINGTON, DC

Chairman Schumer, Ranking Member Saxton, and Members of the Committee, I appreciate the opportunity to appear before you today.

The current financial crisis in the United States poses two separate challenges for economic policy: one, to resolve the immediate problems; the other, to reduce the likelihood that these problems recur. My testimony will focus on the second of these challenges. The diagnosis and prescriptions I will offer are based on a report I am writing with my Brookings Institution colleagues Martin Baily and Bob Litan, of which a preliminary draft will be released this Friday. However, I alone am responsible for any errors or inadequacies in my comments.

The U.S. financial system remains in a perilous state. I share the view of some other observers that the worst of the credit crisis is probably behind us. But that is by no means certain, and, even if it turns out to be right, the return to normal financial conditions will be a slow and uneven process.

Indeed, we have already seen two false dawns during this crisis. Last October and again this January, financial conditions appeared to be stabilizing—only to be followed by renewed widening of risk spreads, further declines in asset values, and struggles for survival by some financial intermediaries. The Federal Reserve has responded to this turmoil vigorously and, in my view, appropriately by reducing the Federal funds rate $3\frac{1}{4}$ percentage points and by providing significant liquidity as the so-called "lender of last resort." Through these actions, the Fed has so far prevented what might have been a cascade of defaults and institutional failures. Hopefully, the relative calm since the sale of Bear Stearns in March is a precursor of further stabilization.

Still, estimates suggest that billions of dollars of mortgage-related losses have yet to be declared by U.S. financial institutions. Interbank loan rates remain elevated as banks hoard liquidity and continue to be concerned about the creditworthiness of other institutions. The slowing of the economy is depressing loan repayment rates. Thus, the risk of a large institutional collapse has been reduced but not eliminated. More important, an absence of dramatic events going forward will not imply that financial intermediation is back to normal. The weakened state of banks' balance sheets will make them less willing to lend to households and businesses for some time to come. For example, the Fed reported recently that a large fraction of banks tightened lending standards and terms across a broad range of loan categories in the first quarter of the year. Many banks have raised additional capital to bolster their balance sheets, but much more needs to be raised. If that does not occur in a timely way, we could face a constriction of lending to households and businesses analogous to the Japanese experience in the 1990s.

The turmoil in the financial system is important primarily because of its impact on the overall economy. The latest data on spending, employment, and production suggest that the economy is very likely in recession, and several forces are exerting further downward pressure on economic activity:

- Housing construction continues to fall sharply, and the large supply of unoccupied homes offers no comfort that construction will recover soon.
- House-price futures and analysts' estimates of sustainable house prices point to further declines, and the resulting loss in household wealth will depress consumption to a growing extent over the next year.
- The tightening in lending that I just mentioned will further restrain spending, as will the weak level of consumer confidence and the rising trend of home foreclosures.
- And this year's further rise in oil prices amounts to a tax on households whose full effect on spending has probably not been apparent yet.

I do not mean to suggest that all of the economic news is bad. Data for the first quarter of the year were more favorable than many had feared, and the decline in the value of the dollar is buoying net exports. Moreover, powerful economic stimulus has been set in motion through the actions of the Federal Reserve and the tax-cut legislation passed by Congress in February. Therefore, I share the consensus view among forecasters that a mild recession is the most likely outcome. But I would caution that a more serious economic downturn is entirely possible.

The experience of the U.S. financial system and economy during the past year vividly demonstrate the need for reform of our financial regulation and supervision. Let me offer four principles to guide reform and the specific recommendations that follow from them:

PRINCIPLE #1: FINANCIAL REGULATION SHOULD TRY TO KEEP PACE WITH FINANCIAL INNOVATION

This principle may seem self-evident, but it is worth stating explicitly because it is so important. Financial innovation has been a very positive force in our economy, but it also creates problems. New products, new markets, and new institutions are usually more complex and less transparent than their predecessors; they tend to boost leverage and risk-taking; and they tend to skirt existing regulations and supervisory attention. In recent years, regulation and supervision of financial institutions did not fully recognize the problems that were building and did not adapt enough to put effective limits on these problems. Going forward, we need to be sure that regulation evolves along with the financial system so that we can reap the greatest benefits of innovation.

Financial innovation has benefited our economy in at least three important ways:

- Innovation in recent decades has extended good opportunities for borrowing and saving to people further down the income scale. The late Ned Gramlich, a former Governor of the Federal Reserve, emphasized last year that the needed reforms of subprime mortgage lending should preserve the good aspects of such lending. He explained that the subprime expansion had enabled many households with low income and poor credit histories to move out of undesirable rental housing, so that even with the current problems, many households will have benefited from this home-owning opportunity. On balance, the democratization of our financial system has been a good thing.

- Innovation has improved the allocation of capital and the distribution of risk in our economy, thereby spurring long-term growth and raising people's well-being. Economists who have systematically compared the experiences of different countries have found that financial development has a significant positive effect on growth rates.¹ In our country, we know that improved access to credit for smaller and riskier businesses—for example, through the expansion of venture capital and the so-called "junk bond" market—has provided critical funds for new industries.

- Innovation has probably helped to stabilize the economy. This statement may be surprising as we stand on the brink of a recession that was caused, at least in part, by innovation run amok. However, I wrote a paper several years ago with Karen Dynan and Dan Sichel in which we tried to catalog the channels through which financial innovation affects economic volatility. We identified myriad channels, with different aspects of innovation pushing volatility in different directions. On balance, we concluded that innovation likely contributed to the mid-1980's stabilization of the U.S. economy known as the "Great Moderation."²

¹ For example, see Aubhik Khan, "The Finance and Growth Nexus," *Federal Reserve Bank of Philadelphia Business Review*, January/February 2000, and Ross Levine, "More on Finance and Growth: More Finance, More Growth?," *Federal Reserve Bank of St. Louis Review*, July/August 2003.

² See Karen E. Dynan, Douglas W. Elmendorf, and Daniel E. Sichel, "Can Financial Innovation Help to Explain the Reduced Volatility of Economic Activity?," *Journal of Monetary Eco-*

Along with these benefits, however, financial innovation also creates problems:

- One key problem with innovation in recent years is the high degree of complexity and low degree of transparency. Nontraditional mortgages—including interest-only mortgages, negative amortization mortgages, and mortgages with teaser rates—were apparently not well understood by many who borrowed this way or lent this way. Unconventional credit-market instruments—such as derivatives on asset-backed securities—were intrinsically complicated and unfamiliar even to sophisticated investors, and they had a very short track record that was exclusively from a period of rapidly rising house prices. Transparency was further reduced by arrangements that purported to insulate investors from risk, such as credit default swaps, bond insurance, and shifting liabilities off balance sheets.

- Another key problem is the increasing divergence of incentives between the ultimate investors and the people guiding financial decisions. These “principal-agent problems,” as economists call them, are endemic in financial markets, but recent innovation has exacerbated them. One example is mortgage brokers who were compensated for the volume of transactions they initiated and had little incentive to monitor the quality of loans they made. Another example is credit ratings agencies that are paid by the sellers of securities rather than the buyers; as securities became more complicated, investors’ reliance on the agencies’ judgment increased.

These problems diluted the potential benefits of the innovation. Democratization of credit is counterproductive if many people end up with loans that are inappropriate for them. Capital is not allocated to its highest-value uses if everyone thinks that the risks of investment are borne by someone else. Lack of transparency and divergent incentives caused a run-up in financial risk-taking, both in the assets purchased and the degree of leverage used to finance those assets. These forces helped to fuel the housing bubble, and they greatly worsened the consequences when the bubble deflated.

In sum, financial innovators and regulators are in a race, and the regulators will always lose that race. But it matters how much they lose by. If regulators do not try to keep up, or are completely outclassed in the race, then much of the benefit of financial innovation will be offset by the cost.

PRINCIPLE #2: MORTGAGE ORIGINATION SHOULD HAVE SIMPLER DISCLOSURES FOR EVERYONE AND LIMITS ON OFFERINGS TO SUBPRIME BORROWERS

Economists and others sometimes assume that having more choices improves people’s well-being. Clearly, that is true in many cases. However, it is not necessarily true if people are choosing among complicated products without sufficient information or understanding.

A growing body of evidence demonstrates that people do not fully understand their financial arrangements. For example, researchers have found that younger adults and older adults tend to pay significantly higher interest rates than middle-aged adults, even after controlling for various personal characteristics.³ This finding suggests different degrees of sophistication across households of different ages. Researchers have also found that households with low income and little education are less likely than other households to know their mortgage terms—for example, the extent to which their interest rates can change.⁴

Financial innovation that gives people more choices can make these problems worse. Newly designed mortgages are generally more complicated than older ones, and people have little experience with new mortgages—in their own lives or the lives of their friends and family members—to use in making decisions. More generally, the ability to borrow more is also the ability to borrow too much. Even in 2004, prior to the worst of the deterioration in lending standards, households with the highest ratios of debt to assets were more likely to be insolvent than in previous decades and more likely to face financial strain.⁵

Of course, protecting people from unwise choices is easier said than done. Financial arrangements that are unwise for some people in some circumstances are quite

nomics, January 2006, and Federal Reserve Board Working Paper, November 2005, <http://www.Federalreserve.gov/pubs/feds/2005/200554/200554abs.html>.

³ See Sumit Agarwal, John C. Driscoll, Xavier Gabaix, and David Laibson, “The Age of Reason: Financial Decisions Over the Lifecycle,” Harvard University, March 2007.

⁴ See Brian Bucks and Karen Pence, “Do Homeowners Know Their House Values and Mortgage Terms?,” Federal Reserve Board Working Paper, January 2006, <http://www.Federalreserve.gov/PUBS/FEDS/2006/200603/index.html>.

⁵ See Karen E. Dynan and Donald L. Kohn, “The Rise in U.S. Household Indebtedness: Causes and Consequences” in *The Structure and Resilience of the Financial System*, Reserve Bank of Australia, 2007, and Federal Reserve Board Working Paper, August 2007, <http://www.Federalreserve.gov/pubs/feds/2007/200737/200737abs.html>.

sensible for other people in different circumstances. Thus, public policy should improve financial literacy and provide information needed for making informed financial choices. However, these steps are not enough in my view, and some limitations on mortgage offerings are also appropriate. Moreover, protecting people also reduces risks for the financial system as a whole, because people who understand their mortgages are more likely to be able to repay them.

Specifically, Martin Baily and Bob Litan and I recommend:

- Simpler mortgage disclosures, pre-mortgage counseling for subprime borrowers, and perhaps a default mortgage contract from which people could opt out.
- Further restrictions on the design of mortgage contracts under the HOEPA rules and a broadening of HOEPA coverage, both along the lines proposed by the Federal Reserve.
- Federal oversight of state regulation for all mortgage originators.

PRINCIPLE #3: FINANCIAL INSTRUMENTS AND INSTITUTIONS SHOULD BE MORE
TRANSPARENT

As we know from many examples, self-interest is a powerful economic force. Good regulation harnesses that force. I have already explained that one important problem with the new financial products and markets of recent years is their very low degree of transparency. By increasing transparency, we can give investors better tools to monitor financial risk-taking themselves.

The private sector is already moving in this direction. Many financial intermediaries recognize that they need to be more diligent in learning about assets before buying them instead of placing blind confidence in other people's evaluations. Going forward, investors will put less weight on the judgment of the credit ratings agencies. They will be more skeptical of assertions that certain complicated financial strategies have no risk. They will be more concerned about the underwriting standards that had been applied to loans underlying asset-backed securities. And they will be less likely to buy derivatives whose payoff structure they do not fully grasp. Warren Buffett has been quoted as saying that he only buys things he understands, and more investors will adopt that mantra.

Appropriate changes in regulation can aid investors in this process. Specifically, Martin Baily and Bob Litan and I recommend:

- Increased transparency in the mortgage origination process, as I have already described.
- For asset-backed securities, public reporting on characteristics of the underlying assets.
- For credit ratings agencies, greater clarity in presenting ratings across asset classes, reporting of the ratings agencies' track records, and disclosure of the limitations of ratings for newer instruments.
- For commercial banks, clearer accounting of off-balance-sheet activities.
- For derivatives, a shift toward trading on exchanges, which will encourage standardization of instruments.

PRINCIPLE #4. KEY FINANCIAL INSTITUTIONS SHOULD BE LESS LEVERAGED AND MORE
LIQUID

Even if private investors had perfect information, they would tend to take greater financial risks than are optimal from society's perspective. The reason is that taking risks in a financial transaction can have negative consequences for people not directly involved in that transaction. These spillover effects arise in part because of the risk of contagion in the financial system, and they arise in part because of the Government safety net including bank deposit insurance and the role of the Federal Reserve as lender of last resort. The parties to a transaction have no reason to take account of these externalities, as economists label them, and this provides the traditional rationale for Government financial regulation and supervision.

To be sure, the financial system is already moving to reduce leverage and increase liquidity. Those institutions with larger capital cushions are weathering this crisis far better than their less-conservative competitors, and they now find themselves in a position to purchase assets at favorable prices. Those institutions with greater amounts of liquid assets have been less subject to "runs" in which their investors scramble to get their money out first. These examples provide strong lessons for future institutional strategies. To highlight one example, the future will see less borrowing on a short-term basis to finance long-term commitments. That approach ended up hurting families who could not afford their adjustable-rate mortgage payments after the rates reset; it hurt so-called "structured investment vehicles" (SIVs) that were not viable when short-term funding costs increased; it hurt municipalities that borrowed in the auction-rate market and were suddenly unable to roll over

their debts at previous rates; and it hurt investment banks that financed themselves heavily through overnight repurchase agreements. In the future, more borrowers will pay higher rates to lock in longer-term financing.

Still, these private responses should be accompanied by changes in regulation and supervision.⁶ Specifically, Martin Baily and Bob Litan and I recommend:

- For commercial banks, capital requirements for off-balance-sheet liabilities, required issuance of uninsured subordinated debt, and closer public supervision of risk-management practices.
- For investment banks, regulation and supervision of capital, liquidity, and risk management.
- For bond insurers, higher capital requirements and closer supervision of underwriting standards for new products.

CONCLUSION

Let me conclude with three final observations.

First, my comments have focused on *what* should be regulated rather than *who* should do the regulating. That is not because I am enthusiastic about the existing hodgepodge of regulation. Rather, I think that regulatory reform needs to set priorities, and the highest priority in my view is not to change boxes on the organization chart but to change what happens inside each box. Insisting on a grand redesign of financial regulation may simply bog down the legislative process and ultimately accomplish very little. To be sure, the seriousness of the current situation and the impact on the housing and mortgage markets that directly affect so many people should provide political support for change. However, regulation of the financial system is substantively complex and will still feel remote to many citizens, and I expect that reform will be difficult to achieve.⁷

Second, the private and regulatory changes that I have discussed will raise the price of risk and therefore the cost of borrowing by risky borrowers. They will also reduce the demand for complex financial transactions, which in turn will diminish the rewards for undertaking this sort of financial engineering. These outcomes are appropriate in my view. During the past fifty years, the value added by the finance and insurance industry has surged from about 3 percent of GDP to about 8 percent. Much of that increase, and the financial innovation it reflects, were beneficial for the reasons I described earlier. But the events of the past year have shown that the latest steps in financial complexity and risk-taking, without appropriate advances in regulation, had smaller benefits and larger costs than many people initially understood. Some step-back in the upward trend of financial engineering should be sought and not feared.

Lastly, financial markets will always experience swings between confidence and fear, and between optimism and pessimism. However, effective regulation and supervision can reduce the frequency, the magnitude, and the broader consequences of these swings.

Thank you very much.

⁶Some analysts have argued that excessive leverage should also be thwarted by restrictive monetary policy. In the words of the IMF's recent *World Economic Outlook*, there may be "benefits to be derived from 'leaning against the wind,' that is increasing interest rates to stem the growth of house price bubbles and help restrain the buildup of financial imbalances." I disagree with this view, principally because monetary policy is a very blunt tool for preventing increases in leverage. More restrictive policy earlier this decade might have diminished the housing and financial bubbles, but only at the cost of significantly higher unemployment and lower inflation at a time when resource utilization was already depressed and inflation was falling toward the bottom of the Federal Reserve's comfort zone. See Douglas W. Elmendorf, "Financial Innovation and Housing: Implications for Monetary Policy," Brookings Institution, April 2008, http://www.brookings.edu/papers/2008/0421_monetary_policy_elmendorf.aspx.

⁷On a related note, I think that regulatory reform should focus on key financial institutions. Economists generally advocate a "level playing field" in which Government rules are neutral across economically identical activities and thus do not distort private behavior. Yet, creating a completely level field for risk-taking and leverage is both impractical and unnecessary. It is impractical because individuals will always find ways to make risky investments and some will undoubtedly lose their wealth doing so. It is unnecessary because these phenomena create larger problems in some circumstances than others. Although mortgage-backed securities and their derivatives spread risks around the global financial system to some extent, significant exposures remained on the balance sheets of key U.S. institutions. It is their losses that have done the most damage to the functioning of the system and created the greatest concerns about future credit supply. Moreover, the Federal Reserve's recent actions show a clear benefit of doing business with key institutions. Tighter regulation can balance the effect of providing that safety net.

PREPARED STATEMENT OF ELLEN SEIDMAN, DIRECTOR, FINANCIAL SERVICES AND EDUCATION PROJECT, NEW AMERICA FOUNDATION, WASHINGTON, DC

Senator Schumer, Representative Maloney and members of the Committee, thank you very much for this opportunity to testify before you concerning the regulatory implications of and guidance we can take from the current market failures. My name is Ellen Seidman, and I am the Director of the Financial Services and Education Project in the Assets and Ownership Program at the New America Foundation. Our project is focused on the development and implementation of policies that will encourage responsible consumer financial services, enabling consumers to use our powerful financial system to build, rather than destroy, their assets.

I also continue to serve as Executive Vice President, National Program and Partnership Development, at ShoreBank Corporation, the Chicago-based bank that is the nation's first and largest community development bank holding company and its largest community development financial institution. I also serve on the Boards of two other large and well respected community development financial institutions, the Low Income Investment Fund and Coastal Enterprises, Inc. Each of these companies is both devoted to and in fact provides responsible financial services for lower income communities, businesses and individuals in the parts of the country they serve.

From 1997 through most of 2001, I was the Director of the Office of Thrift Supervision, the Federal agency that regulates the savings and loan industry. I draw on all these experiences for many of the points and recommendations I make today.

Before I get to recommendations, let me step back a moment and consider how we got here. I think there are three root causes: the unsustainable buildup of systemic risk; an antiquated, uneven and frequently ineffective regulatory system; and a loss of alignment between serving customers well and standard business practices.

First, we have allowed systemic risk to buildup to what has obviously become an intolerable level. The risks include those that were known but hidden—from consumers, from investors, from participants in the system, from regulators; risks that were unknown, often because firms had created such a degree of complexity that even the best efforts at ferreting out risk would have failed; and risks that were unknowable—the model failures that Chairman Volcker talked about in his Economic Club of New York speech. Excessive leverage and reliance on short-term funding to support long-term assets exacerbated the impact of these risks.

Second, we have both tolerated and allowed to grow a regulatory structure that has two major failures. First, entities performing the same kinds of functions are regulated very differently, with the general effect that business practice flowed downhill to the practices of the least regulated. But second, we have not focused our regulatory attention tightly enough on what really matters. Is finding every last SAR violation really more important than making sure that the recourse on SIVs is adequately capitalized? Or that borrowers have an ability to repay? Our regulatory system has become simultaneously unduly complex, ineffective where it counts, and excessively burdensome on some of the least risky and most consumer-friendly elements of the system.

Getting this balance right is hard. In my tenure at OTS, I know we sometimes got it right, as when we stepped in early to keep thrifts from engaging in payday lending. Sometimes we got it wrong, most spectacularly in the Superior Bank failure. And sometimes we did things that seemed right at the time but had, in retrospect, some negative unintended consequences. An example of this is the sub-prime guidance all the regulators issued in 2001 that to my mind was in part responsible for pushing sub-prime lending out of banks and into less regulated affiliates. But the fact that it's hard means that we'll sometimes get it wrong, not that we are excused from trying.

Third, we have lost incentives for financial institutions to provide high quality, consumer friendly products that provide long-term value. This is a result with many causes: the originate-and-sell business model that, especially when tied to brokering at the front and CDOs on the back, has separated the interests of borrower and lender and of principal and agent; not extending the affirmative service mandate of CRA beyond banks and thrifts; the manner in which CRA and other consumer protections were—or weren't—enforced; failure of financial literacy to keep up with a fast-changing financial world; and not focusing our imagination and creativity on ways to help consumers gravitate to products and services that are beneficial to them while also profitable to providers.

This is not just being nice to consumers. As should be obvious from the mess we're in now, the financial viability of institutions is inextricably linked to that of their customers—including consumers. To give just one example, with the advent of the secondary market, the long-term fixed-rate fully amortizing mortgage should have

been a dynamite product: lenders get to charge for long-term use of money that is likely to be used for a much shorter period and borrowers get a steady, predictable payment schedule that builds equity. Somehow that's not what happened.

So what do we need to do? In the face of the mess families, communities, companies and markets now confront, I believe the critical question is how can we reestablish in our financial markets and companies a long-term, quality-oriented culture that incents all parties to focus their attention on:

- products and services that benefit both lender and borrower;
- complete, accurate and transparent risk assessment and management; and
- profitability and growth that is sustainable over the long term?

Obviously this is not a job solely for a regulatory system, and it is just as obviously not easy. But I think if we set this as a goal, we will have a standard to measure our thoughts and proposals against.

I suggest six critical strategies:

- First, *Effective Enforcement*: the will and financial wherewithal to enforce the laws and regulations we establish. Without this, we are not only allowing bad things to continue to grow, we are fooling ourselves into believing we've resolved problems. And this is not only an issue at the Federal level, but also at the state level, where regulatory agencies are frequently starved for resources.

- Second, *Risk Assessment*, namely concentration on enhanced risk knowledge and transparency: within organizations, among organizations, for the public, and to and among regulators, both domestically and internationally. We can no longer afford to have institutions that do not know their own level of risk and that of their counterparties—and regulators who are also in the dark. As noted, this will not be perfect; there will always be unknown and unknowable risks, but let's at least get rid of the hiding.

- Third, *Capital Adequacy*, with increased capital all around. This has three critical effects. First, capital serves as the penultimate guard against institutional collapse. Second, because capital is at risk, it serves to mitigate against excessive and foolish risk-taking, of the "heads I win, tails you lose" variety. Third, if all entities in the system are required to hold a greater amount of capital, demand for returns based on financial leverage should diminish. And by the way, it's time to recognize that in an uncertain world, loss reserves are in practice part of the capital structure and to allow them to serve a counter-cyclical function by building up during good times so they can be drawn down during the bad that will inevitably follow.

- Fourth, *Enhanced Responsibility*, a system where all players have skin in the game, realigning the interests of borrowers, lenders and all those in the chain between money provided and money used. For institutions, it's capital in part, but an explicit continuing residual interest in sold assets whose value depends on future performance should also be considered. And certainly we need to do something about compensation systems—both individual and institutional—that do not recognize back-end risk. What if deferred compensation for executive officers were required to be haircut if the bank received a CAMELS rating of 3 or lower within the following 2 years—with equivalent sanctions for non-banks? And certainly the days of paying mortgage brokers up-front fees with no hold-back for performance should be over. In this connection, I urge Congress to move ahead with consideration of the two sets of bills related to the mortgage crisis that are pending: those dealing with regulation of the market and those responding to the crisis for homeowners, communities and the markets.

- Fifth, *Regulatory Consistency* across entities that are performing the same tasks, such as providing consumer credit or brokering significant financial services for consumers, and/or have access to the same kinds of benefits, such as the discount window. At the same time, we need to be cognizant of actual risk and relate it to actual burden. Regulation is a fixed and a hidden cost, and smaller institutions both have fewer options for dealing effectively with regulators and smaller budgets within which to absorb the costs. Again, this is tough, but in enhancing regulation, as I believe we need to do, especially with respect to risk management and consumer protection, it's essential that we not destroy the financial viability of the smaller institutions closest to the people, including community development financial institutions, credit unions and community banks and thrifts.

- Finally, *Aligning Incentives with Practices* that treat customers fairly and equitably, before, during and after their purchase of financial services. There are many ways to do this, including not only consumer protection legislation and regulation—and let me voice my support here for the regulators to stay strong as they move toward final rules under HOEPA, TILA and the Federal Trade Commission Act and for Congress to move forward on pending legislation—but also establishment of a suitability standard for those selling or brokering significant consumer credit products; an enhanced and more broadly applicable Community Reinvestment Act; pub-

lic information systems that extend beyond the Home Mortgage Disclosure Act to enable the public and the media to see who's being served, who's doing it well and who's doing it badly; improving financial literacy; and barrier removal and incentives to help consumers do the right things, such as the pension opt-out provisions that were incorporated into the Pension Protection Act of 2006.

As markets begin to stabilize or we reach what I suspect will be temporary lulls in foreclosures or house price declines, it will be easy to fall back into believing that the status quo is acceptable, that changing it is too hard, or that enhanced regulation of consumer products will hurt consumers by limiting choice. Such a result would be not only dangerous and a mistake, but also a waste of the trauma and turmoil we've been through. Let's instead use this experience to learn, think creatively, and act.

PREPARED STATEMENT OF ALEX J. POLLOCK, RESIDENT FELLOW, AMERICAN
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REGULATORY IMPLICATIONS OF THE HOUSING AND MORTGAGE BUBBLE AND BUST

Mr. Chairman, Ranking Member Saxton, Vice Chair Maloney and members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a Resident Fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI in 2004, I spent 35 years in banking, including 12 years as President and CEO of the Federal Home Loan Bank of Chicago. I am a director of three financial services companies and a Past President of the International Union for Housing Finance. I have both experienced and studied many credit cycles, of which our 21st century housing and mortgage cycle is the latest example.

The Human Foundations of Financial Risk

The severe housing and mortgage bust we are experiencing can best be understood as the inevitable deflation of a classic asset bubble. Historically speaking, why do we keep having these financial adventures, no matter what our technological and theoretical progress or regulatory reorganizations? Why is "a prudent banker one who goes broke when everybody else goes broke"? This witty line of Keynes points us to the eternal human elements behind the credit overexpansion that our sophisticated, globalized, computerized, and leveraged markets produced between 2003 and 2006, the subsequent debt panics of 2007 and 2008, and the continuing bust.

The losses of the bust are now being recognized in the general, "Main Street" banking system. Note in this context that 48 percent of the total loans of insured depositories are based on real estate. For the vast majority of banks, those with total assets of less than \$1 billion, this number is 67 percent.

The human nature behind the bubbles and busts does not change, whether the calculations of boundless future profit from increased leverage are made with quill pens or advanced computers. Credit overexpansions are always based on a belief—the first optimistic, and then euphoric, belief in the rising price of some asset class.

The belief in the ever-rising price of the favored asset seems to be confirmed on all sides as the bubble expands. As long as the underlying price, of houses in our current case, keeps rising, everybody wins—borrowers and lenders, brokers and investors, speculators and flippers, home builders and home buyers, rating agencies and bond salesmen, realtors and municipalities, and many others. Bubbles are notoriously hard to control because so many people are making money from them while they last.

Political actions also play a role. In the housing bubble, politicians of both parties also thought they were winning as all sides cheered increasing home ownership ratios and expanding "access" to mortgage credit with lower credit quality loans. The government has been an effective promoter of higher loan to value lending and smaller down payments—such as recent proposals to move the FHA to 100 percent LTV loans—riskier lending, and the use of government guarantees. A 1994 "National Homeownership Strategy," for example, advocated "financing strategies, fueled by creativity" for those to become home buyers who lack the cash or income to buy a home. A good deal of "creativity" was indeed subsequently applied.

Of course, bubbles always come to a sad end. Retreating eastward after the collapse of the bubble in Kansas land prices in the 1880s, defaulted farm mortgage borrowers put on their wagons: "In God we trusted, in Kansas we busted."

This time expectations of house price increases entered the models analyzing subprime mortgage pools as "HPA," or house price appreciation. What ultimately emerged was naturally HPD: house price *depreciation*. So we can update the Kansas motto of 120 years ago to: "In HPA we trusted, with HPD we busted."

Can regulation avoid these cycles?

Was There a Regulatory Golden Age?

Some current discussions give the impression that there used to be a time when highly regulated banks dominated the credit system, so regulators prevented problems. Was there such a "golden age" of regulation? No, there wasn't.

In the 1960s, Federal regulation of deposit interest rates (the infamous "Regulation Q"), which can be viewed as having created a Government-sponsored deposit cartel, caused two severe credit crunches—those of 1966 and 1969, in which mortgage credit would get rationed out.

Consider the mid-1970s, when commercial bank lending created a bubble and massive bust in loans to real estate investment trusts ("REITs"). The Senate Banking Committee held hearings wondering whether the entire commercial banking system was insolvent on a mark-to-market basis. (Needless to say, the banks did not mark their assets to market.)

Savings and loans were then the most intensely regulated of financial institutions. The result? By 1979, by following their fixed rate lending regulatory instructions, in the aggregate they were insolvent on a mark-to-market basis. The insolvency of the savings and loans laid the foundation for the move to mortgage securitization.

How about the 1980s? Well, more than a thousand commercial banks failed in this decade. There were massive credit busts in loans to developing counties ("LDCs" in the jargon of the time), in energy finance, and again in commercial real estate loans. In all cases, we are speaking of loans on the balance sheets of the banks. The insolvency of the saving and loans grew much greater, causing the insolvency of their Federal deposit insurer, "FSLIC," and of course ending in collapse and bailout in 1989, along with regulatory reforms and restructuring.

In 1993, in the wake of these reforms, the financial historian Bernard Shull insightfully wrote:

Comprehensive banking reform, traditionally including augmented and improved supervision, has typically evoked a transcendent, and in retrospect, unwarranted optimism. The Comptroller of the Currency announced in 1914 that, with the new Federal Reserve Act, "financial and commercial crises or panics. . . seem to be mathematically impossible." Seventy-five years later, confronting the S&L disaster with yet another comprehensive reform. . . The Secretary of the Treasury proclaimed "two watchwords guided us as we undertook to solve this problem: Never Again."

Yet here we are again. In the meantime Congress also imposed the expensive Sarbanes-Oxley Act to manage corporate risk. It was so successful that we have nearly had a global financial collapse.

The British formed a consolidated financial regulator, the "FSA," and separated its role from the Bank of England. But when the Northern Rock funding panic and crisis hit, this structure did not work well. No matter how you organize any government activity (or company or anything), as time goes by, you will have to reorganize it. The perfect answer does not exist. However you try to engineer a regulated market or industry, the reactions and adaptations to the regulatory engineering require another reform, and another, and so on ad infinitum.

My point is not that no action should ever be taken, but that we have to be realistic about the adaptations to and unforeseeable effects of all interventions. I am against utopian hopes for what financial regulation can achieve, but I am for sensible improvements.

Here are a number suggestions for such improvements:

- Simple and straightforward disclosure in one page
- Remove government support for rating agencies
- Encourage credit risk retention by mortgage originators
- Countercyclical management of LTV ratios
- The "Super Fed"
- Increased GSE responsibility for refinancing the bust
- Controlling "fair value" accounting
- The study of financial history

I will discuss each briefly.

Simple and Straightforward Disclosure in One Page

I have previously testified to this Committee that we should require a clear, straightforward, one-page disclosure to borrowers of the essential information about prospective mortgage loans. The information, in regular-sized type, should focus on what commitments the borrowers are making and how much of their household income these will require, so they can "underwrite themselves" for the credit. This would be a major improvement in the American mortgage finance system.

Mr. Chairman, thank you for introducing S. 2296, which would implement this idea, which everybody should be able to agree on. I hope it will be included in any final mortgage legislation.

And thank you, Vice Chair Maloney, for your interest in the possibility of using the one-page approach in another area, overdraft disclosures.

Remove Government Support for Rating Agencies

The credit rating agencies say that they are in the business of publishing opinions about the future. In this I believe they are right, and I have a good deal of sympathy with the thought that in the course of financial events, some such opinions will prove to have been mistaken, even disastrously mistaken. So when it comes to opinions about the future, more opinions and competition is likely to uncover new insights into credit risks and new methods of analysis.

A particularly desirable form of increased competition would be from ratings agencies paid solely by investors, as opposed to those paid for by the issuers of securities, as many commentators have suggested.

But here is a larger question: Since all opinions are liable to error, and opinions based on models are liable to systemic error of vast proportions—as the subprime bust makes apparent—why should the U.S. Government want to enshrine certain opinions as having preferred, preferential, indeed mandatory, status? It shouldn't.

I suggest that all regulatory requirements to use the ratings of certain preferred rating agencies be eliminated. Banks and other regulated investors should instead be responsible for developing their own prudent standards, which would probably entail the use of credit ratings as part of a credit management system—but without government sponsorship of the dominant firms.

Encourage Credit Risk Retention by Mortgage Originators

One of the lessons of the savings and loan collapse was that for depository institutions to keep long-term fixed rate mortgages on their own balance sheet, while funding them with short-term deposits, was extremely dangerous in terms of interest rate risk, although it was no problem in terms of credit risk. The answer was to sell the loans to bond investors through securitization and divest the interest rate risk to those better able to bear it. As a side effect, the credit risk was also divested.

In the wake of the mortgage bubble and bust, we now realize that divesting the credit risk created big problems on its own, breaking the alignment of incentives between the lender making the credit decision and the ultimate investor actually bearing the credit risk. Some commentators have referred to the good old days when the savings and loans kept the loans themselves—how short the memories are of the disaster that caused.

The right synthesis of the historical lessons is for securitization to continue to address interest rate risk, while encouraging the retention of significant credit risk by the original mortgage lender. There are numerous regulatory and accounting obstacles to this approach, but its obvious superiority makes it worth while to try to overcome them. This is an assignment which should be given to an appropriate group of financial regulators.

Countercyclical Management of LTV Ratios

As asset prices rise in a bubble, more debt and leverage always seems better. The credit experience of loans financing the inflating asset will be good, with delinquencies, defaults, and losses all low. Thus, the risk of the loans seems to be decreasing, even while the risk is in fact increasing.

The low delinquencies and defaults seem to confirm the success of the credit expansion and the accuracy of the lending models. Loan-to-value (LTV) ratios rise, even while they should be being reduced. "Innovative" no-down-payment mortgages are promoted. This inflates the price and credit bubble further, and insures that the ensuing bust will be worse.

A rational, countercyclical management of LTV behavior would reduce LTV ratios as the price of the asset inflates beyond its trend—this is the opposite of what in fact occurs. How one might make this happen should be the subject of another study.

The "Super Fed"

I believe the "Super Fed" idea contained in the Treasury Department's restructuring proposal is consistent with the original situation in 1913, the year of the Federal Reserve Act, as well as the current financial world. This idea would have the Fed serve as stability, systemic risk overseer and lender of last resort to the financial markets in general.

Much has been made of the Fed's extending discount window lending to investment banks, rather than only to commercial banks. But separation of banking into

these two parts did not occur until the Glass-Steagall Act of 1933. In 1913, for example, J.P. Morgan and Co. was still both an investment bank and a commercial bank; it did not divide into Morgan the commercial bank and Morgan Stanley the investment bank until forced to in 1935.

Today Morgan is again both a commercial bank and an investment bank, after the repeal of Glass-Steagall in 1999, and will be even more so with its pending acquisition of Bear Stearns, as arranged by the Fed. The "Super Fed" proposals seems sensibly to deal with the financial structures of the present and the future, as opposed to those of 1933–1999.

Increased GSE Responsibility for Refinancing the Bust

As I have previously testified to this Committee, it seems to me that in exchange for the manifold advantages Fannie Mae and Freddie Mac receive from the government, they should be assigned a larger role in refinancing the troubled loans of the mortgage bust.

Controlling "Fair Value" Accounting

I know Congress does not like to get involved in the theoretical—one could say the metaphysical—disputes of accounting. Still, the current accounting fashion of "fair value" accounting has played an important role in the financial problems of the last 10 months. There is no doubt in my mind that "fair value" accounting is pro-cyclical, that it accentuates reported losses in times of financial panic and helps encourage the boom in times of optimism. Is there some way to control its perverse effects?

Among the key questions which must be addressed are:

- What does a "market price" mean when there is no market?
- Should panicked levels of fear and uncertainty determine accounting results?
- Should accounting be about the recording of cash-flows over time or the theoretical buying and selling of assets and liabilities?

I don't suggest that it is easy to answer such questions, only that they are in fact legitimate policy issues.

The Study of Financial History

"The mistakes of a sanguine manager are far more to be dreaded than the theft of a dishonest manager," wrote Walter Bagehot. The best protection against excessively sanguine beliefs is the study of financial history, with its many examples of how easy it is to be plausible, but wrong, both as financial actors and as policy-makers. Perhaps we need a required course in the recurring bubbles, busts, foibles and disasters of financial history for anyone to qualify as a government financial official. I have the same recommendation for management development in every financial firm.

Thank you again for the opportunity to share these ideas.