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RESTORING THE ECONOMY: STRATEGIES FOR SHORT-TERM AND LONG-TERM CHANGE

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BEFORE THE

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JOINT ECONOMIC COMMITTEE

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THURSDAY, FEBRUARY 26, 2009

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

The committee met at 10:00 a.m. in Room 106 of the Dirksen Senate Office Building, The Honorable Carolyn B. Maloney (Chair) presiding.

Representatives present: Hinchey, Cummings, Snyder, Brady, Paul, and Burgess.

Senators present: Schumer, Klobuchar, Webb, Brownback, Risch, and Bennett.

Staff present: Nan Gibson, Gail Cohen, Marc Jarsulic, Colleen Healy, Justin Ungson, Andrew Wilson, Jeff Schlagenhauf, Jeff Wrase, Rachel Greszler, Chris Frenze, Bob Keleher, and Robert O'Quinn.

OPENING STATEMENT OF THE HONORABLE CAROLYN B. MALONEY, CHAIR, A REPRESENTATIVE FROM NEW YORK

Chair Maloney. The Committee will come to order. I want to welcome my colleagues, and I particularly want to welcome former Chairman Volcker and all of our other outstanding witnesses, and thank you all for your testimony today.

Chairman Volcker, when it comes to understanding the economy and financial markets, you are in a league with only one player. We are tremendously honored that you are the first to testify before the Joint Economic Committee this Session.

Over the past two days, we have heard rather sobering testimony from Fed Chairman Bernanke, that even under the best of circumstances, our economy remains perhaps a year away from making a full recovery.

The problems plaguing the real economy and the financial system, are intertwined, so it is critical that we act as swiftly as possible. At the core of the ongoing liquidity crisis, is the decline in home prices. Home prices continued their free-fall at the fastest pace on record, in December.

Since the beginning of this crisis, Congress has been working on keeping families in their homes. Today, the House will consider and pass the Helping Families Save Their Homes Act, which will help families stay in their homes, and will help stabilize communities by spurring loan modifications and avoiding bankruptcy.

Strong indications are that this downturn could be the worst in the post–World War II period, and, Mr. Chairman, you have indicated such yourself.

The current recession, which began in December of 2007, has caused massive job loss and decline in economic growth. Congress recently passed the nearly $800 billion American Recovery and Reinvestment Act, which provides fiscal stimulus in the form of aid to state governments, infrastructure spending, increased breaks to middle-class workers and families.

This package is designed to stem the real human costs and our economic losses, by creating millions of jobs, helping families in need, and investing in the future.

The concern, though, is that the effects of our recovery package may be blunted, if the financial crisis lasts too long. The Federal Reserve has taken extraordinary steps to maintain the operation of our financial and credit markets, but, clearly, we need a comprehensive plan to return to well-functioning markets.

In his address to Congress on Tuesday night, the President pledged to work with Congress to adopt new rules of the road, a reformed financial regulatory structure to prevent future crises and hold financial executives accountable.

Our entire regulatory system is in serious need of renovation. It failed to properly identify the risks in the mortgage-related assets; it did not recognize that these risks were being concentrated in highly-leveraged and important financial institutions; and it failed to anticipate the dangers posed to the financial system as a whole.

It also failed to provide mechanisms for dealing with the failure of important, non-depository financial firms. These shortcomings must be addressed, regulators must obtain better information, better measurement of system vulnerabilities, and the authority necessary to head off threats to financial stability.

It is obviously too costly to leave the regulatory system as it is.

As the winter turns to spring, my hope is that these efforts will break the downward spiral of our economy and bring about a thaw in credit markets, but, even more may be needed to be done, and that's what we will be finding out about today.

I look forward to our witnesses' views on reviving our economy and restoring our financial markets. Again, thank you very much, Chairman Volcker, for coming, and the Chair recognizes Ranking Member Brownback for five minutes.

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

OPENING STATEMENT OF THE HONORABLE SAM BROWNBACK, RANKING MINORITY, A U.S. SENATOR FROM KANSAS

Senator Brownback. Thank you very much, Chairwoman Maloney. I appreciate that. Chairman Volcker, it's good to have you here. I look forward to your comments and your thoughts.

I picked up the Wall Street Journal this morning, and, boy, I don't like what I see headlining things: "$318 Billion Tax Hit Proposed," and an article right underneath it, "Pair Live Large on Fraud," saying they misappropriated $553 million; lavish homes, horses, and even an $80,000 collectible teddy bear.

I don't know where you find a teddy bear of who pays something like that, but my point in raising that, is that while we're trying to put gas into the tank of the economy, to put a $318 billion tax hit, doesn't seem to be the mixture of medicines we're talking about.

That seems to be hitting both the accelerator and the brake at the same time. And then the fraud that's in the system, really drives people nuts, crazy.

I want to read to you, a letter that a medical doctor at the University of Kansas facility just had published in the Economist Magazine. I think he summarizes what most folks calling into my office say. This is Dr. Frederick Holmes, Kansas City, Kansas, who said this, quote:

"Responsible people and responsible institutions have not hurled themselves lemming-like, into the abyss of ruin. Despite the death knell sounded throughout the media, most people and most banks did not encumber themselves with mountains of unsecured debt.

In the conservative heartland of America, we've avoided the razzle-dazzle of sophistication and computerized modeling when managing our finances. I have entrusted a locally-owned bank in Kansas City with my money for more than 40 years, and it has been a good steward of my modest wealth.

Last year, the Chief Executive posted a brief notice on the bank's website, to reassure depositors. It read, 'When the siren song of the subprime mortgage market came along, we took the long view and turned a deaf ear.'

I'm going to leave my money with the folks at this bank for the next 40 years, for they seem to have the intelligence and common sense largely absent in the leadership of large banks."

Now, that summarizes a lot of what I get, calls in my office, and then they see articles like this in the Wall Street Journal and other newspapers, and they think that this has not been handled right, it's big money center banks that are doing this to us; it hasn't been appropriately reviewed, regulatory-wise, and now they're going to take more money out in taxes.

This doesn't seem to be the prescription for us to come out of a deep recession. It's been and is a very difficult recession, there's just no question about it. People are hurting. We're getting people laid off in a number of industries and places across my state. It has not been good.

But it doesn't seem like the idea of raising taxes, is a good idea at this point in time. It doesn't seem like that this has been properly regulated in the big money center banks, in particular, and it seems like Wall Street has driven this onto Main Street, more than anything else that's been seen.

What I hope to hear from you, is, are these accurate, and how is it that we get at the big center bank issues that don't make people across the country pay for it, that didn't do some of these sophisticated investment techniques that have driven us down so hard and far, and don't require them to pay the bill, the people that are on Main Street paying the taxes.

Now, I appreciated, over the years, your thoughts and your writings and your comments, and I hope they are full of wisdom, as well, today, as they have been in the past. Thank you, Chairwoman.

[The prepared statement of Senator Sam Brownback appears in the Submissions for the Record on page 54.]

Chair Maloney. Senator Klobuchar, for one minute.

OPENING STATEMENT OF THE HONORABLE AMY KLOBUCHAR, A U.S. SENATOR FROM MINNESOTA

Senator Klobuchar. Thank you very much, Madam Chairwoman. Thank you, Chairman Volcker, for being here.

I just want to follow up on something that the Senator said, which is that there are banks that are solid, including some large banks, including many of the banks in Minnesota. I wrote the other day that some of these credit unions and the smaller banks in my state, are sort of clutching their sensible briefcases, trying to keep their feet planted in the heartland, with all the debris swirling around them, saying, Toto, we're not in Kansas anymore. I thought you'd appreciate that, Senator Brownback. [Laughter.]

Senator Klobuchar. But the truth is, how do we restore the confidence in the market, when we know that some of these major banks, many out of Wall Street, are in such trouble, when others aren't? So much of this, to me, seems that we need to restore the trust in the market, the confidence in the market, because we know that the current situation doesn't just hurt banks; it hurts people who can't get a mortgage or people who can't get an auto loan or kids that can't get a student loan.

So, that's what I'm looking forward to hearing about today, as well as the changes to the financial regulation of the market that we need to make.

Thank you very much.

Chair Maloney. Thank you. I recognize Congressman Brady from the House, for five minutes.

OPENING STATEMENT OF THE HONORABLE KEVIN BRADY, A U.S. REPRESENTATIVE FROM TEXAS

Representative Brady. Thank you, Madam Chairman. I'd like to welcome Chairman Volcker, as well. I think it's widely agreed that nothing else we do will matter much, until the issue of how to dispose of toxic bank assets is resolved.

Neither the Bush nor the Obama Administrations has devised a solution to this admittedly difficult problem. The recent Treasury proposal has not been well received, because it did not clearly address this issue.

The Economist Magazine, for example, said it looked "depressingly like TARP I—timid, incomplete, and short on detail." The lack of specifics has undermined confidence and contributed to financial market instability. A better approach is needed to help foster recovery.

Madam Chairman, in the interest of time, I'd like to insert my complete statement. I do believe, as Senator Brownback does, that the dramatic increase in the deficit, our record-setting and dangerous debt, along with the inability to really address the core of this crisis, is really moving us into terribly risky areas, and I'm eager to hear Chairman Volcker's guidance on how we move forward.

[The prepared statement of Representative Kevin Brady appears in the Submissions for the Record on page 56.]

Chair Maloney. Thank you very much. Congressman Snyder for one minute, and welcome to the Committee.

Mr. Snyder. Thank you, Madam Chair. I hear myself talk all the time, I look forward to hearing Chairman Volcker.

Chair Maloney. Congressman Burgess, for one minute.

OPENING STATEMENT OF THE HONORABLE MICHAEL BURGESS, A U.S. REPRESENTATIVE FROM TEXAS

Representative Burgess. Thank you, Madam Chairwoman. I hear myself talk all the time, too, and I can't get enough of it. [Laughter.]

Representative Burgess. Chairman Volcker, I appreciate you being here with us this morning. I appreciate you sharing your testimony with us beforehand.

I was struck by the paragraph toward the end of the second page, where you talked about repeating the story of how we got to where we are today. I need to say that the fundamental lesson of the crisis is that future policies should be alert to and take appropriate measures to deal with persistent economic imbalances.

Mr. Chairman, I just hope you'll address, when you give us your testimony, does the—and I won't go through the entire litany, because Chairman Brady just did,—but the $700 billion on TARP, the $787 billion of the stimulus, the $650 billion healthcare down payment we're going to be required to approve, the $75 billion you paid for housing, the $75 billion that's coming for Iraq, does this represent, in and of itself, a persistent destabilizing effect on the economy?

Is this, in fact, a deficit bubble that we're going to have to witness the carnage that occurs when that, in fact, bursts? The most fundamental thing that people back in my District want to know, is, you can have so much regulation, but if nobody enforces the regulation, what good is it?

There's malfeasance out there. How are we going to demonstrate to the American people, that once and for all, someone is going to be held accountable for what has been the greatest train robbery in American history? I yield back.

Chair Maloney. Mr. Cummings, for one minute.

OPENING STATEMENT OF THE HONORABLE ELIJAH CUMMINGS, A U.S. REPRESENTATIVE FROM MARYLAND

Representative Cummings. Thank you very much, Madam Chairlady, and, welcome, Chairman Volcker. I'm anxiously looking forward to hearing your testimony.

I represent a District like my colleagues, where so many people are losing their homes, they've lost their savings, they're losing their houses, can't get loans, businesses going out of business, and I know that—I'm sure that you won't say that you know all the answers, but your opinion is well respected.

We need to try to figure out a way to use the money that we are spending, effectively and efficiently. I think the American people will be patient, but they will be patient, only if they know that we are good stewards of their money.

I hope that you will shed some light on what you think will help us, the kind of policies that will help us become or be efficient and effective with their funds. With that, I yield back.

Chair Maloney. Thank you. Mr. Paul, for one minute.

OPENING STATEMENT OF THE HONORABLE RON PAUL, A U.S. REPRESENTATIVE FROM TEXAS

Representative Paul. Thank you, Madam Chairman. I, too, hear my voice all the time, and I'm sure the rest of you are tired of hearing it.

But, nevertheless, I will take a moment. In California, they worry about the big one, the big earthquake, and I think, financially, the big one is here—the very big one.

And nobody seems to know what to do about it, and I think it's because they don't quite understand how it came about. It's been building, the bubble has been building since 1971, but it has exploded.

I visualize it as we in the Congress and the Federal Reserve are there with a tiny little pump, pumping into a bubble that has a huge hole, and the longer you pump, the poorer this country is going to get, and there will be no solution. Even a bigger pump is not going to solve the problem.

In the past year, we have run up a debt of an additional $1.5 trillion. We've created about $9 trillion worth of credit in the financial system, and it hasn't done any good.

We have to reassess what we're doing, because I think we're on the wrong track.

Chair Maloney. Thank you very much. Senator Bennett, for one minute.

Senator Bennett. Thank you very much, Madam Chairman. Chairman Volcker, you were one of the architects of our recovery from the Great Inflation, you are a student of the Great Depression, and I look forward to hearing what you have to say now, with the great whatever it is we ultimately decide to call this mess. Thank you.

Chair Maloney. Thank you. I would like to welcome Chairman Volcker. Paul Volcker is a man who needs no introduction.

He has an impressive record of achievement and service. It's very long, but let me just say he is very important. He is currently the Chairman of the President's Economic Advisory Board, and the former Chairman of the Federal Reserve Board of Governors.

In the course of his career, Mr. Volcker worked in the Federal Government for almost 30 years, culminating in two terms as Chairman of the Board of Governors of the Federal Reserve System, from 1979 to 1987.

He divided the earlier stages of his career between the Federal Reserve Bank of New York, the Treasury Department, and the Chase Manhattan Bank.

Educated at Princeton, Harvard, and the London School of Economics, Mr. Volcker is a Professor of International Economic Policy at Princeton University, and was the first Henry Kaufman Visiting Professor at the Stearn School of Business at New York University.

Thank you very, very much for coming, and please proceed with your testimony.

STATEMENT OF THE HONORABLE PAUL VOLCKER, CHAIRMAN, PRESIDENT'S ECONOMIC ADVISORY BOARD, AND FORMER CHAIRMAN, FEDERAL RESERVE BOARD OF GOVERNORS, WASHINGTON, DC

Chairman Volcker. Thank you very much, Madam Chairwoman, Members of the Committee. It's a—I hesitate to say "a pleasure" to be here, given the circumstances, but I welcome the chance to testify before you.

There's no secret that we live in a difficult time of enormous complexities, complications and risks, and a depressed economy. You've set out a very ambitious title for these hearings, "Strategies for Both Short–Term and Long–Term Change," and I will try to address that a bit, and then look forward to the conversation.

But I'm sure we all agree that the purpose of all this, is to develop approaches that will not again leave markets so vulnerable that a breakdown can again threaten the national and world economies. That is what has happened now and it's what we don't want to happen in the future.

But in approaching this, I want to step back from the immediate financial crisis, to emphasize that this is not just a financial crisis; it is an economic crisis, in the sense that this country was proceeding for some years—I don't know as I want to go back to 1971, Mr. Paul, but we can go back a decade or so, when we began spending, as a nation, much more than we were producing and much more than we were able to produce.

The inevitable result of that, was heavy reliance on borrowing from abroad. It took place in an atmosphere where personal savings in the country disappeared, and that process, which was supported by a lot of cheap imports from China and elsewhere in Asia, also supported by the willingness of those countries to buy U.S. securities, so interest rates were low, we didn't have any inflation, we were spending like crazy, what's so bad about that?

You know, everybody likes to consume, and there wasn't any strong urge to do something about it. But gradually—or not so gradually, it built up more and more debt, inevitably, and that debt eventually had weaker and weaker foundations, partly because of the great art of financial engineering, and, in particular, in the housing market, the debt was built up on weaker and weaker mortgages.

That all came back to haunt us, in effect, when the economy turned, house prices were no longer going up; they leveled off and came down, and the mess that we're in, was triggered.

So I just want to emphasize that this is not just a—it is, indeed, a crisis of Wall Street; it's a crisis of financial markets, but it reflects the fact that we had a tremendous buildup of debt, a lack of savings in the country, and too much reliance on fragile debt.

Now, I noted that this buildup in debt was facilitated and extended by the modern alchemy of financial engineering. People went into financial markets and made a lot of money. They developed mathematical techniques that were supposed to diffuse and limit risk. It turned out, in practice, in the end, in many cases, to magnify and ensure risks, and that was certainly true in the subprime mortgage market.

We lost transparency, risk management failed, and at the same time, I think, highly aggressive compensation practices encouraged risk-taking, right in the face of misunderstood and almost incomprehensible debt instruments.

That was the dynamic of this process—a combination of tremendous incentive to take risk, and complexities and obscurities as to what those risks were.

So, obviously, as we look ahead, we need more discipline, financial management, better risk management, and reform of compensation practices.

Now, let me say that as this crisis has evolved, it's exposed all sorts of other weaknesses, weaknesses in accounting, weaknesses in credit-rating agencies, weaknesses in other market practices.

I won't go into detail, but I think it's fair to say that fair-value accounting rules were inconsistently applied. They have contributed to a downward spiraling of valuations in our liquid markets. Credit-rating agencies clearly failed in analyzing some of these complex new instruments.

We have weaknesses in clearance, settlements, and collateral arrangements for obscure derivative contracts that grew up very rapidly in recent years.

These are technical issues that are very difficult to deal with through legislation, but we have to pay attention to them and they do need to be resolved.

You've already pointed out the concern, the legitimate concern about lapses in financial regulation and supervision. They certainly permitted institutional weaknesses to fester, the regulators failed to identify exceptional risks, they failed to deal adequately with conflicts of interest, and as was pointed out in the press again this morning, they did not expose large—huge, personal scandals, even after warnings.

So that's going to require close attention by the Administration and the Congress, and I will be surprised if you do not conclude that very substantial changes have to be made.

Taken together, the need for change is both obvious and wide-ranging. In approaching the challenge, I do urge that all these matters be considered in the context of a considered judgment about the appropriate role and functioning of the financial system as a whole, in the years ahead.

At the most general level, I'm certain we would all like to see a diverse, competitive, predominantly privately-owned and managed institutions and markets able to efficiently and flexibly meet the needs of global, national, local businesses, governments, and individuals.

That sentence is a mouthful, but I took it directly from the recent report of the Group of 30, setting out a framework for financial stability, which you and your staff may have seen. We issued it recently. It does point out the extent of the challenges ahead, if we're going to end up with a reformed financial system, and I recommend it to you.

It makes a lot of recommendations—18 general recommendations, some of them with a corollary. It does not cover all the specific things we could talk about. It doesn't make recommendations at this stage, about how the administrative structure should be reformed, what the Federal Reserve should do, what the Comptroller of the Currency should do, the SEC, and so forth.

That's important, but I think the most important thing is that we have some judgment about what the system should look like, so we know what we're aiming for and what should be regulated.

I do think the report makes some points that are common ground among almost all people that have looked at this. There is agreement that all banking organizations have to come within the framework of an official safety net.

The natural corollary is regulation and supervision, and, beyond that, it's also recognized that a few of the banks, and possibly some other financial organizations, are so large and their operations so intertwined in complex relationships with other institutions, as to entail systemic risk.

In other words, the functioning of the financial system, as a whole, could be jeopardized in the event of a sudden and disorderly failure. Consequently, those institutions should be subject to particularly high international standards, directed towards maintaining their safety and soundness.

Now, as I see it, and as the philosophy of the report represents, these banking organizations should be predominantly relationship-oriented. Their function is to provide essential financial services to individuals, businesses of all sizes, and government.

To help assure their stability and continuity, and to limit potential conflicts of interest, strong restrictions in risk-prone capital market activities, hedge funds, equity funds, proprietary trading, and the like, would be enforced—strong restrictions.

At the same time, trading- and transaction-oriented financial institutions that operate primarily in the capital markets, could be less intensively regulated, although I think there is a need for stronger registration and reporting requirements.

In instances where the institutions are so large or otherwise so complex as to be systemically relevant, capital leveraging and liquidity requirements would be imposed.

Now, implicit in this approach, is the need for strong cooperation and coordination among national authorities and regulators. Some approaches—accounting standards, capital liquidity requirements, registration and reporting procedures—should be internationally agreed and consistent in application. That's necessary to minimize regulatory arbitrage and any tendency by particular countries or financial centers, to seek competitive advantage by tolerating laxity in oversight.

Now, all of this will take time, if the necessary consensus is to be achieved and a comprehensive, rather than piecemeal approach is taken. I also recognize that a coherent vision of the future should help guide the emergency responses to the present crisis, and, even more important, the steps, difficult steps that will be taken as the truly extraordinary measures now in place, are relaxed and ended.

So I hope that will proceed, and I welcome the opportunity to participate in your deliberations.

[The prepared statement of Paul Volcker appears in the Submissions for the Record on page 57.]

Chair Maloney. Thank you so much, Chairman Volcker, for your testimony. Chairman Volcker, before we get to our questions, could you just comment on any positive aspects that you see in our economy? Do you have any good news for us in economic recovery? Government's been working very hard.

Chairman Volcker. Some silver lining is behind all those dark clouds, and, in fact, there are a few. In recent weeks, we have seen some relaxation of the tensions in the securities markets, broadly defined.

Interest rates have come down in those areas, a number of corporations have successfully been able to finance in the long-term markets. The short-term market, where the authorities have been very active, have been showing some signs of life, resuscitation in the commercial paper markets, so, in those areas, a certain amount of confidence seems to be returning.

In the banking area, obviously, you still have a lot of tension, concern, declining stock prices, and so forth, so I'm not beginning to say that the crisis is over, but in some areas of the market, you can see a relaxation of the tension, which is very helpful.

Now, you do, as I read in the papers—Chairman Bernanke was testifying yesterday—you can get this kind of spiraling situation where the weakness of the economy itself brings more pressure on the banks. The more pressure the banks have, the less they can lend or are willing to lend, which weakens the economy, so we still have to deal with that threat.

Chair Maloney. Thank you. Yesterday, Chairman Bernanke testified before the Financial Services Committee, and he testified that he considers nationalization to occur when the government wipes out the shareholders, 100 percent, and takes over a bank, and that he did not envision taking such draconian measures with respect to any financial institutions in the United States.

Could you comment on what lessons we learned from history about the effectiveness of government investment in private financial institutions, short of nationalization, such as in Japan, as compared with examples of countries that have gone 100 percent, such as Norway or Sweden, and just your general comments on nationalization?

Chairman Volcker. Well, "nationalization" has kind of become a dirty word, a very emotional word, anyway, and people use the word without defining very carefully, what they mean. Chairman Bernanke had one definition yesterday, of 100 percent ownership.

But let me say, in general, nobody—very few people are in favor of government ownership of businesses or financial institutions. I certainly am not and I don't want to look towards that kind of an organization of the marketplace.

I don't think that's at issue. The question is, what degree of government support is necessary at this particular point in history?

Some of these institutions, some of the banking institutions, have clearly got a capital problem. They've got some bad loans, their capital has been depleted. The best thing that could happen, is they go into the markets and recapitalize themselves.

Right now, that is not really feasible in many cases. Because they have to be recapitalized, I think we ought to look to the private markets to do it, to the extent possible, but if that's not possible, I'm afraid we have to look to the government to fill the gap, temporarily.

We have to have—I would not call that "nationalization;" I would call that capital restructuring, which is necessary and which the government may, and already has participated.

You'd like to see that as little as possible, but if it's necessary, I think that is an approach that has to be understood and not only tolerated, but, in a sense welcomed as a way of temporarily maintaining the stability of the system.

Some of these institutions are already subject to substantial governmental control; you see that every day. The government is so involved in guaranteeing assets and guaranteeing liabilities and controlling what they do in some respects, what they sell, what they buy, we're living with more government control and influence than we would like to see, and we want to get away from that when we can.

Chair Maloney. One of the problems is the so-called toxic assets that the financial institutions have. There are a number of approaches that have been put forward, such as public/private partnerships to address this. Do you have any comments on how you feel this challenge should be handled?

Chairman Volcker. Well, I think, in some cases, some way of removing or isolating the bad loans, is desirable and necessary to restore confidence and the full-scale effective operation of these banking institutions.

Now, it's very easy for me to make that sweeping statement, and then you asked me how to implement that and you have questions, which I do think can be dealt with, but it will take government support and participation.

But I think there are various methods that have been discussed for removing some of those assets from a bank, at a determined price, which is obviously going to be less than their initial value, and you get those assets removed and into what is sometimes colloquially called "the bad bank."

You develop a technique for financing that bank, dispose of the assets over a period of time, and then leave the rest of the bank, the bank itself, the so-called "good bank," in a position where it may be able to raise capital on its own, because its bad assets or some of them, a large proportion of them, will be taken out.

If they can't be, the question of some government participation in the capital restructuring, naturally enters. I think that's the essence of some of the proposals and programs put out yesterday by the Treasury.

Chair Maloney. My time has expired. Senator Brownback?

Senator Brownback. Thank you very much Chairwoman. Thank you very much, Mr. Volcker, and I appreciate your historical knowledge and perspective.

Yesterday, Chairman Bernanke talked about this negative feedback loop, and you mentioned it today. Do you see particular weak points in the feedback loop, that we should try to target in on, to break it?

Because that's what I'm seeing now, as well, is that we've got one is feeding the other, downward in this spiral. Are there places that you can look at to go to break that feedback loop?

Chairman Volcker. Yes, there are. Now, how effective and how workable they are, obviously, we're seeing in practice, but there are really three areas that are important:

The first was the stimulus bill that tried to keep the economy higher than it otherwise would be, and, therefore, slow down the adverse feedback loop that you describe.

The second is, and where we have not been successful so far, is going directly to the mortgage problem where this crisis really centered at the beginning, and the problem if declining house prices and failures of the mortgages and the inability of many people to maintain surface on their mortgages.

Here's where you have, obviously, a very real human problem coinciding with the market problem of a general threat to the financial system.

Now, you have a new program there proposed by the Administration. We'll see how that works. I hope it works with some success.

Then, finally, we get to what we're talking about, which is, can you break the loop by defending the stability of the institutions that are threatened by the slowdown in the economy and the impact on their own assets, and that's what we're talking about in recapitalizing the banking system.

Senator Brownback. You broke the big inflation period, and you were one of the key architects of that. By the way, I was one of the key persons dealing with the pain from some of that.

I shouldn't say one—I was one of the very small people dealing with much pain. I was a young lawyer——

Chairman Volcker. Short pain, I hope, for long benefit.

Senator Brownback. I mean, it was a very real thing, because I was representing a number of farmers and small banks, and they had borrowed money at high interest rates and the land continued to inflate underneath them, and all that broke, and, boy, there was—we lost over 100 banks across Kansas in that decade.

It worked, but it was very painful in the process. But my point on asking this and about the Depression, is, what's the historical model that you look at, that says it's most akin to where we are now?

Chairman Volcker. Well, in terms of the banking situation, for better or worse, in fact, quite a few examples.

The big one, I suppose, was in Japan, where they had a situation very similar to ours, in that they had an economy that had been operating at a very high level with great confidence, but they built up both very high stock values, as we did in the 1990s, and then even higher real estate values.

They both collapsed, in their case, at the same time.

And they had even sharper declines that what we've had, both in stock prices and in real estate values, where real estate values, I think, there, went down by 75 percent, at least in urban areas.

And they struggled with that for some years, because it was a great shock to the banking system, they did not have highly-engineered open markets; they didn't have a subprime mortgage market, but they had a banking system that was reliant on loans that were backed by assets, particularly real estate assets.

The assets collapsed, so the banks came under great pressure. The government had to eventually come in and provide them with new capital.

They did not take as forcible action as we were just talking about, in terms of taking out the bad assets and in recognizing the failures of a lot of companies. A lot of people have said that—pointed out that that's not an example we want to follow.

I would also point out that they had a lot of intervention, and the economy, while it did not do well, did not go into a Great Depression, either, or a great recession. We just kind of sat there sluggishly for a decade.

So——

Senator Brownback. And I don't think they—did they increase taxes in that period of time?

Chairman Volcker. I think at one point, they did. They got very worried about the budget deficit, and increased——

Senator Brownback. Is that a way for us to go?

Chairman Volcker. I would think not, in general, but I—you know, you can talk about specific taxes, and you might want to make changes, but if you're talking about a broad-based tax increase, I don't think anybody's talking about a broad-based tax increase at this point.

Senator Brownback. That was the headline in the Wall Street Journal today.

Chairman Volcker. Well——

Senator Brownback. A large increase in taxes, which——

Chairman Volcker. That startled me when I saw the headline, too, but then I saw the next sub-headline, and it said, over ten years. So that's dividing $800 billion or whatever it is, by ten, that's $300 billion. What was it? I can't remember.

Whatever it was, you divide by ten and it doesn't look quite so formidable.

Chair Maloney. Your time is expired. Congressman Snyder?

Mr. Snyder. Thank you, Madam Chair. I also think that the proposal was not a broad-based tax increase; I think it's very targeted to those who have done very, very well in this last decade.

Chairman Volcker, I wanted to ask you, every once in awhile, we see news footage of a volcano that decides to put out a massive amount of lava, and the lava flow is coming down the mountain and the pitiful efforts of humanity to try to stop a lava flow, and the lava always wins, it seems to me that the lava in this particular situation, is our helper, that the lava flow that's coming, is the drive of people to support themselves, to make a living, to produce products to sell to other people, and that that's what's coming down the mountain, if we can just figure out a way to make the changes we need, the lava flow will take care of itself.

My question is, do you see anything in the list of items you went through in a very articulate manner this morning, anything out there that's not solvable?

Chairman Volcker. No, but I think some of it is, indeed, very complicated. It certainly is solvable, but it's going to take—it has taken much more government intervention than we would ordinarily like to see, quite obviously, and it's going to take—I think we at least have to be prepared for the fact that it's going to take more government money, particularly in helping with the recapitalization of these financial institutions.

But, yes, I certainly think it is solvable, and I think we can do it in a way that we emerge from this with a more solid financial system that, for many, many years, I'm inclined to say, for my lifetime—and that's not very impressive anymore; it's not as impressive as it used to be—for your lifetime, a lifetime of anybody in this room, we wouldn't be faced with this kind of crisis once again, revealing structural weaknesses in the financial system. We ought to repair it—not just repair it; we ought to reorganize it.

Mr. Snyder. With the result being not that we just somehow get through this, but that we set the table——

Chairman Volcker. Absolutely.

Mr. Snyder.—for potentially remarkable economic growth, not only here, but around the world and see more than few hundred million people lifted out of poverty.

Chairman Volcker. The one thing I would plead in that respect, is, we have to take emergency actions. We're taking emergency actions, we're going to take more emergency actions, but when it comes to reorganizing the financial system, let's take our time.

Now, I don't want to overemphasize that. I don't think we should do it piecemeal. We ought to have some vision of what the financial system ought to look like, and it's not entirely in the control of this country. I a globalized world, it's going to have to be—some parts of it are going to have to be uniform, more or less, some more, some less, but around the world, and we ought to come to some kind of vision that is reasonably shared.

Then we can put the pieces together, and I hope we can do that fairly soon, but we can't do it—you're not going to do it in the first half of this year, and I don't think we should try.

Mr. Snyder. You had mentioned several things in your written and oral statements that you describe as technical issues and some accounting rule things that I think you stated and most of us would agree, would not be appropriate for legislative solutions.

Do you have any apprehension that we may, indeed, try some legislative solutions in some areas that we should stay the hell out of?

Chairman Volcker. Yes.

Mr. Snyder. Are you going to let us know when you see that coming?

Chairman Volcker. Well, I think accounting is one area where the temptation is to kind of march in and sweep away, I don't know, mark-to-market accounting or something. It's a complex technical area and I think changes have to be made.

I'm a bit prejudiced here, organizationally, because I used to be Chairman of the International Accounting Standards Committee, which appoints the Board, which makes the accounting standards, and I don't necessarily agree with all those standards, and I think they have to be looked at, but they have to be looked at in a kind of professional way, that maybe isn't very conducive to the immediate political process.

So I hope that's one area where you would keep the gun in the holster.

Mr. Snyder. Stay away.

Chairman Volcker. Yes.

Mr. Snyder. I think there has been a remarkably smooth transition in our national security apparatus from one Administration to the other. I think probably Secretary Gates staying on, was a key to that, but my impression is that it has gone very, very smoothly throughout the Pentagon and in the military.

My question is, are you satisfied with how smooth the transition has been in these areas that we're talking about today, from one Administration to the other, or are there things that could be done with more alacrity?

Chairman Volcker. Well, in general, I think it's been smooth in the sense that some of the key positions were filled soon with competent people, and people well understood the problem.

There is an area that I think is—I don't know, but "shameful" is the word that comes to mind. The Secretary of the Treasury is sitting there without a Deputy, without any Under Secretaries, with no—so far as I know, no Assistant Secretary responsible in substantive areas, at a time of obviously very severe crisis. He shouldn't be sitting there alone.

Now, various things have contributed to this, I guess, including vetting procedures, but it really is an unfortunate situation that I believe the Treasury Department, which I was once in and I thought it was the best job I ever had and have great pride in that institution, but just in recent years, has been weakened before the transition, and it deserves some attention and rebuilding, and new strength.

You can't be the leading economic power in the world, with all the problems we have, and have a weak Treasury.

Chair Maloney. Thank you. Your time has expired. That was an excellent point, Mr. Chairman. Congressman Brady?

Representative Brady. Thank you, Chairman, and thank you, Mr. Chairman, for being here today.

I have two questions. Your comment in your opening remarks, was that this was an economic crisis, brought upon us by spending more than we are producing, a tremendous buildup of debt, lack of personal savings, and reliance on foreign debt.

All of those we seem to be doing more of on steroids. If that was the path to the economic crisis, how does running down that road faster solve the problem?

Chairman Volcker. Well, it won't, that's for sure, but you have a very difficult balancing to do. We weren't saving enough, we were spending too much.

Now, you get into this crisis, and people flip right to the other direction, understandably. They're worried, they're concerned, they're losing their jobs, so, suddenly, they stop spending and are trying to save more, and in terms of a smooth economic adjustment, there's a risk of going too far in the other direction.

We've got to build up the savings, we've got to have less consumption, relative to economic activity, and not less consumption in absolute amounts.

And these changes tend to come in spurts. This spurt is downward. So, you've got to take action that somehow looks contrary, as you say, to hold it up so that it doesn't go too fast in the wrong direction.

Representative Brady. Does that same scenario apply to government, when we're spending far more than we are producing, when we are building up a tremendous amount of debt, when we're relying on foreign debt, does the same risk that applies in the private market, apply in government?

Chairman Volcker. Yes. I think it's less fragile at this point, with the government building up the debt. It's a byproduct, I guess, of the support that the private economy needs, but you are emphasizing, I think, what I would certainly agree with, that during this period, we've got to pay attention to how we get the federal spending back into some reasonable relationship with what we're willing to tax.

And I think the President is conscious of that. He had some meetings about that earlier this week, but, you know, it's—that may be one area where this Board that I have been appointed Chairman of, that we could start and may want to look at. What can we do to reinforce a sense that we really can get spending back on track as this emergency recedes?

Representative Brady. Well, I would certainly like to help with any of those measures.

Let me ask you about TARP II. You know, when the initial plan was laid out, it was not well received by economists or the financial markets. It may have, in fact, added to turmoil.

You were named shortly beforehand, as head of the President's Economic Recovery Advisory Board. Did your panel have enough time to thoroughly analyze it and evaluate it?

Chairman Volcker. That was before we were appointed, the first TARP, but, anyhow, we have not been active yet. We're just getting active. We had nothing to do with that.

Representative Brady. Is it important that the Administration start clarifying that? I mean, do you have any insight today on details? How are we going to take those, isolate those bad loans, remove those toxic assets?

That seems to be what everyone knows needs to be done; the question is, what is going to be done?

Chairman Volcker. My impression is, that's under very active discussion in the Administration, as well as outside the Administration. The question is, there are complexities beyond my particular knowledge, in terms of law and authority and so forth and getting it done.

I believe it can be done, and I hope it will be done expeditiously. And that will require, when you talk about—talk to or whatever—I think it is quite possible and may be desirable, in doing it cleanly and effectively, to provide a certain amount of government capital to make that process possible.

It's difficult to do it, I think, without government support, either in the form of guarantees or cash, or maybe both. We've got to get some organization able to hold those assets, and they're not going to get financed, unless there is some feeling that they are financeable.

Representative Brady. I think many of us were hoping that you had had some impact on that financial plan, or are having some impact on it.

Chairman Volcker. Well, I think that, you know, discussions are ongoing. I think that the quicker it gets resolved, the better.

Representative Brady. Right, thank you, Chairman, very much.

Chair Maloney. Thank you. Congressman Cummings?

Representative Cummings. Thank you, Madam Chair. Chairman Volcker, yesterday, it was reported by Bloomberg News, that Chairman Bernanke said that if the government ended up with a substantial share of Citibank stock, adequate oversight of Citi could be accomplished by the government, through the regulatory process and through the exertion of shareholder rights.

Chairman Bernanke is quoted as saying "It may be the case that the government will have a substantial minority share in Citi or other banks, but again, we have the tools, between supervisory oversight, shareholder rights, and other tools, to make sure that we get the good results we want in terms of improved performance."

If the government were exerting shareholder rights to accomplish its objectives, Chairman Volcker, would that constitute a form of nationalization, and would it be adequate to protect taxpayers' investments in these institutions?

Chairman Volcker. Well, my own feeling is, calling that "nationalization," which is an emotive term, apparently, may be misleading, in terms of what is really going on.

There is undoubtedly government influence and there will be government influence and there will be more government influence. That's true, the influence, is true today and it's going to continue.

But it is—I would put it in a characterization as government support for recapitalization.

That sounds less threatening, somehow, than "nationalization." It doesn't imply we're doing this as a permanent, desirable method of running the economy or running the financial system. It is not.

We want to do it to speed the return to a privately-capitalized system.

Representative Cummings. And if the regulatory process and the exertion of shareholders' rights, are truly adequate to accomplish the good results we want in terms of improved performance, why is the regulatory oversight not apparently working now to increase lending and to prevent banks from receiving aid from doing things like going on these junkets and paying for Cheryl Crowe and things of that nature?

Chairman Volcker. Well, in terms of the lending, I think the principal problem is that an insecure bank faced with what it sees as insecure borrowers, is not a very eager lender. It's a problem of lack of good borrowers, confident borrowers, as well as weak banks and worried bankers.

And so you can attack one end of this by cleaning up the banks, the way we described, some key banks, and I think that will help, but it's part of a general economic problem to create an environment in which people want to borrow and demonstrably can show the kind of support that makes it justifiable to lend.

I'm sure there are instances now where perfectly solid borrowers are unable to get money. But there aren't as many of those as there used to be.

And there are weak banks that don't want to go back in the hole, so to speak.

Representative Cummings. Mr. Chairman, that leads me to this point: You know, a lot of our constituents don't understand what you just said. They don't understand that.

They look at all of this money flowing into these banks, and they believe that there should be a connection between their hard-earned taxpayer dollars flowing into their banks, and their ability to get credit to educate their kids, to, you know, keep their businesses going or whatever, and are you saying that it's unreasonable for them to assume that there will be a connection there?

Chairman Volcker. I think there is a connection, but it's a connection that will work out over time, by strengthening the banks, as well as the economy. There is not an easy connection to say, you know, a million dollars is going into Bank X, and, immediately, directly related, that a million dollars is going out to borrowers of Bank X.

You know, the money all goes into the bank, generally. You can't tag those dollars.

Representative Cummings. I understand that, and my time is running out, but I think this is it; I think people are not—I don't think they expect that million dollars to be loaned out, but they expect maybe $250,000 to be loaned out, and they can hold on to the 750.

Chairman Volcker. Well, fair enough, but I can't trace that, either. But you want that money to be lent out over time, but it's got to be part of a process of stabilizing the bank.

Until you get the bank stabilized and confident, the money isn't going to flow very well, so the whole object is to restore some stability to the banking system and some confidence to the banking system, and you've got to do it in an atmosphere where the economy out there isn't very good, to say the least.

I think that's the basic object. Going to people, going to your constituencies and saying it's kind of a vague, just hold on a bit and we hope to get on top of this, isn't the best story you can give them. I think that's, unfortunately, the reality.

And I think it's understandable that to get those bank loans made, you've got to get the banks in better shape.

Representative Cummings. Thank you very much.

Chair Maloney. The gentleman's time has expired. Congressman Burgess?

Representative Burgess. Thank you, Madam Chair. Chairman Volcker, let me just pick up on what Mr. Cummings was asking you because there's no question there's a crisis of credibility. We in Congress deal with very low approval ratings, certainly bankers right now have very low approval ratings.

As the Administration knew, the public is stipulating confidence in the Administration, but Bill Moyers recently introduced Simon Johnson, formerly the Chief Economist of the International Monetary Fund, and Mr. Moyers said that the new Treasury Chief of Staff was formerly a lobbyist from Goldman Sachs, and I'm quoting now, “The new Secretary of State, was, until last year, an executive of Citigroup; another CFO from Citigroup is now an Assistant to the President, and the Deputy National Security Advisor for International Economic Affairs and one of his deputies, also came from Citigroup. One new member of the President’s Economic Recovery Advisory Board, comes from UBS, which is being investigated for helping rich clients evade taxes,” end quote.

Now, Mr. Johnson noted that most of these appointees were well intentioned but with backgrounds that will make it hard for them to be totally objective about the bank bailouts.

Now, to Mr. Cummings’s point, if our constituents ask us why so many former bank officials should be given these important positions in the Administration, what do we tell them?

Chairman Volcker. Well, you’ve got to tell them that, obviously, to deal with this very complex situation, you have to have people that deal with financial markets and have experience in financial markets.

I’m not going to get into which particular individuals those should be or which banks they come from, and I think they should come from a variety of sources, for, partly, the reasons you suggest, to give a sense of confidence and rounded judgment.

But, beyond that, I don’t know what I can say. These are areas of difficulty and complexity that are recent enough, so you don’t have a lot of people out there that are necessarily very imbued with all the problems that exist, and they’re going to have the best ideas of getting out of it. But you hope to get the best you can.

Representative Burgess. And I would certainly agree that you don’t want to exclude people who have the expertise. We see that all time in the energy industry and the pharmaceutical industry where we seem to have——

Chairman Volcker. It may be that—you know, I referred to the problems of getting a Treasury man, that the rules about backgrounds and conflicts of interest and so forth, is probably one of the factors inhibiting getting the Agency speedily manned.

So, you know, it’s kind of a hard balancing act.

Representative Burgess. Well, with the crisis in confidence, though, it’s important to get those things right.

Chairman Volcker. I agree with that.

Representative Burgess. Now, when Senator Brownback was asking you questions, I think he referenced the crisis in the economy in the 1980s, shortly after your tenure, when the savings and loans collapsed around the country.

I was a young physician in North Texas at the time, and it was a very, very painful time, as I recall. But you pointed out that it was relatively short, I mean, as far as episodes of pain go, and that there was a significant prolonged benefit in North Texas, probably 25 years of sustained economic growth and really only until the last couple of months, where the recession in the rest of the country caught up with North Texas.

You also outlined the situation in Japan, where a similar set of circumstances and the recovery and the growth just never happened, because of perhaps some differences in approach.

So I would just ask, at this point where our approach seems to be more like Japan’s today, should we be perhaps more like your approach and the person who followed you at the FDIC, the approach back in the 1980s, to the savings and loan problem?

Chairman Volcker. Well, let me tell you what I think the big distinction is between the problem we have now and those incidents that you referred to earlier. The Texas crisis, if I may call it that, certainly began on my watch. It wasn't quite completed on my watch, but it was there.

The Texas banking system collapsed, as you recall. The four or five big Texas banks, didn't exist after the crisis, and the savings and loans subsequently came under great pressure.

Now, what happened? It was a tough time for Texas for awhile, but it wasn't a tough time in the United States, and Texas is a big state, but it's not the whole United States.

And the crisis took place in the environment of a growing environment and a pretty stable economy, and that helped to get out of the crisis relatively quickly.

Japan is a big country and it was more difficult, but, still, Japan is not the United States. Now you have a crisis that goes right across the United States, and the problem is not just across the United States; it's in the whole world.

Production is declining outside the United States, from a high level; it's declining more rapidly than anything I've seen in my lifetime. Now, the level of activity is still pretty good, but they are in recession and we're in recession.

So when everybody's in recession, it's much harder to get the momentum to get out. There's no other place you can grab to to hang on, so to speak, there's no big sea of stability out there, it's rough seas all over.

And that is—I think it's unique in the post–World War II period, to have this degree of recession right around the world. I think you're going to have a decline in GNP around the world this year, which will be a small decline, because China and India are still growing, but it's very unusual to have a decline in economic activity right around the world.

That makes it harder for us to climb out. That's why it takes so much force, so much money, so much effort here, because we're fighting the headwind.

Chair Maloney. Thank you. Congressman Paul?

Representative Paul. Thank you, Madam Chairman. Chairman Volcker, some of your comments sort of frighten me, not because you remind us that we're in an economic and financial crisis—and I'm satisfied that you admit that, especially since it's a reflection of the monetary and financial system that we've been working with for so long—but some of the suggestions you make give me some concern.

But I did date our current problem from 1971. I won't quibble over the dates, but 1971, to me, was significant, because it ended the monetary order of the Bretton Woods Agreement, and that was a major, major event. That was a gold exchange standard and it was flawed and it failed.

In 1971, we, as a nation and as a world financial system, we accepted a paper dollar as the reserve dollar of the world. And I think that's related to a concern that you have and I have, and every single economist I've ever talked to in Treasury or in the

Federal Reserve, have expressed the same concern, and that is the current account deficit, which, again, didn't start in the 1970s, as much as exploded in the 1980s and the 1990s.

We're the biggest debtor nation in the history of the world, and we recognize that, but where the difficulty comes, is to understand why we got there. I put the blame on the dollar standard, because we became the privileged nation, that we were allowed to print the gold. The world accepted it and they still do, to a large degree, and they're still taking our dollars.

But I think the handwriting on the wall now, is that that system has ended and all the inflating and all the manipulation and all the spending, will not put that system back together again.

So there's a lot of people now thinking about coming up with that replacement, and that's what I'm concerned about. I want to study and understand and maybe have some influence on it.

There's a few of us, and there's a growing number who believe in the free market, sound money, and national sovereignty, and believe that you can have a world economy without violating any of those principles.

But in your next to the last paragraph, is where I find some frightening things, because you talk about a strong coordination among national authorities, unified accounting standards and liquidity requirements, and internationally-agreed to, and it has to be comprehensive and not piecemeal.

Now, that invites a lot of questions, to me. Is this going to be a super IMF? Are we going to revive the SDRs? Who's going to issue the credit? What will happen to the Dollar? Who has the authority?

These are major things. I'd like to know what kind of discussions are going on internationally right now, to devise a standard, and are you a participant in these international negotiations to come up with this new system?

Chairman Volcker. Well, I think the answer to that question is, no, no. I mean, I don't know of any coherent or regular discussions going on officially and a very few going on unofficially, in terms of the construction of the monetary system.

Now, the comments that you quoted from my testimony, are directed toward, I suppose what you might think of as secondary considerations, how you regulate whatever system you have, how you regulate banks and other institutions and financial systems. It's kind of a lower level of generality.

The questions that you raise, are relevant questions. I agree with much of your description. We may not agree upon remedies, but I'll tell you, I don't think anybody is very seriously thinking about that right now. Nobody's talking about a super IMF.

They have been talking, until recently, about the IMF not having much to do. We suddenly changed that in the regulatory area, where they may have some responsibility.

I would like to see the questions you're raising, debated. That's not what I meant to raise in this statement.

Representative Paul. But do you think they're—so you think there is a need. Do you think the system we have today is over and done with and that we can't patch it together and just more trillions of dollars of credit by the Fed and more debt by the Congress is going to solve this problem?

Chairman Volcker. I think there are problems with the present international monetary system that have not received sufficient attention. I'll leave it at that.

Representative Paul. That's ducking it a little bit.

Chairman Volcker. Yes, yes, I agree, because I can't tell you the answers are apparent, but make no mistake about it; this is a unique moment in economic history, where the world is going on the basis of fiat currencies. That's what economists like, and they thought it was a good idea, and let currencies float up and down, and don't get constricted by gold or other artificial arrangements. But it's a little tricky.

If you're going to run on a world of fiat currency, you better pay attention to the stability of that currency and the maintainability of the currency, and I think we are inclined to forget about that.

Representative Paul. It just may be that——

Chair Maloney. The gentleman's time has expired. Senator Bennett?

Senator Bennett. Thank you very much, Madam Chairman. Chairman Volcker, we're going to great lengths to try to remove the toxic assets from the balance sheets of the various institutions, or, failing that—that was the first description of what TARP would do—failing that, substitute capital in these institutions, so that their balance sheets look stronger.

Let me walk through an alternative scenario that's presented to me, and get your reaction. And I will reduce it to the smallest possible example, a single mortgage.

And let's put a dollar figure on it of $400,000, and it's a mortgage that's going bad, and whether it goes into foreclosure or whatever, it's under water, and the most that it could be refinanced for, would be $300,000.

And if it goes into foreclosure, it probably gets sold on the open market, if it's sold at all, for $150,000 to $200,000.

And then the problem comes that bits of that mortgage are now in packages that are in London and Los Angeles and Chicago and Kuala Lumpur and wherever all else, so that all through the system, no one knows what their package is worth.

Now, if that mortgage were refinanced, and, therefore, retired, all of those institutions that own a bit or piece of that mortgage, suddenly get well, as far as the value of that mortgage is concerned, because it's gone.

Is that a true statement?

Chairman Volcker. Well, are you saying that that mortgage disappears?

Senator Bennett. If the mortgage is refinanced.

Chairman Volcker. Refinanced.

Senator Bennett. In other words, it's paid off.

Chairman Volcker. Yeah, well, the creditor, presumably, is getting less than he expected when he made the mortgage.

Senator Bennett. Yes.

Chairman Volcker. He might be making more than he can reasonably expect now.

Senator Bennett. But the mortgage is paid off by a refinancing.

Chairman Volcker. Right.

Senator Bennett. Does that mean that the toxic assets disappear on the balance sheets of all of the institutions, that particular toxic asset?

Chairman Volcker. Well, I don't think so. You may end up with good assets, if you did that, generally, but the value of those assets would be less than the stated value of the so-called toxic, so you would have lost capital someplace along this line.

Senator Bennett. Okay, now, let me follow through on my time here and get it right. Let's say the mortgage is refinanced at $400,000, but at a vastly lower interest rate, so that the individual paying the mortgage could now afford it.

That means that the original mortgage disappears completely and no one down the chain loses any money; is that not true?

Chairman Volcker. Well, they lose money, because they're making lower interest than the other than what they thought they were going to make.

They may be gaining compared to the present situation, yes.

Senator Bennett. A 30-year mortgage is traditionally retired in seven years, so somewhere, the mortgage disappears.

The thing that is intriguing to me, is the possibility that by making housing mortgages available at a significantly lower rate, let us say three percent, so that the homeowner who is currently under water, says, okay, I can keep paying on the $400,000 mortgage at three percent, so I will refinance, so the original mortgage is paid off, therefore, the toxic asset disappears from everybody's balance sheet, and we're now in a situation where everybody has paper whose value they know. Wouldn't that have a significant impact on stabilizing bank's balance sheets?

Chairman Volcker. If you could do that amid all the technical and legal complications of dealing with these mortgages that are buried, as you point out, in big instruments where there are thousands and thousands of mortgages in every particular security, and you get through all the restrictions on how those mortgages can be refinanced under the rules under which the big securities are put together, yes. Now you've got a political problem. Who are you going to help?

Are you just going to help those in trouble, or are you going to help everybody? And if you help everybody, it's getting pretty expensive.

You probably get as many as I do, but at least twice a week, somebody writes me about a scheme for how to, one way or another, do the kinds of things you're talking about.

And some of them look very attractive to me, so I send them off to somebody who's supposed to know more about it than I do, and the Administration, as you know, came up with their judgment as to how to approach this.

And they have come up with a scheme which they think is less costly and more effective, by dealing directly with reducing interest rates on particular mortgages, according to some formula as to what's affordable.

Is that best way to do it?

They concluded, that's the best way to do it. I haven't got any reason to question that at this point, but it's not the most sweeping thing that could be done.

What you're suggesting, is much more sweeping, also much more costly.

Senator Bennett. My time has expired, but, I, too, asked somebody who's smarter than I am, because I just asked you. Thank you. [Laughter.]

Chair Maloney. Thank you, Senator. We are very pleased that the Vice Chairman, Senator Schumer, has joined us, and the Chair recognizes him for five minutes.

Vice Chairman Schumer. Well, thank you, Madam Chairperson, and first let me wish you luck. You won't need it; I know you're going to do a great job as Chair. I thoroughly enjoyed my tenure as Chair, and I'm very confident that you're going to do a great job at a time when this Committee is more important and more relevant than ever before.

Thank you, Chairman Volcker, for your years of service to the country and for everything else that you have done.

My first question is a broad question. You know, we're all looking to point a finger of blame at this particular person or that particular person, for this crisis.

I think there's plenty of blame on individuals, but in the broad—there's plenty of blame that should go to individuals, no question.

But in the broad brush, you could look at this crisis and say the following, the broadest brush, at least, that I see it: When a country, year after year, consumes more than it produces, imports more than it exports, borrows more than it saves, the chickens always come home to roost.

You may not be able to predict how they come home to roost, but they do, because it is unsustainable to continue to do that, if economics means anything.

And so my question to you, is this: When, let's hope and pray we get out of this financial mess that we're in, how does America get back to those old values?

Is it inevitable that in an affluent society, we lose and we just become, in a sense, a giant, stuffing our face with cake all the time, so to speak?

Are there government policies that we should be looking at now, that help us get back to that?

Will the pendulum just swing back inevitably and get us there?

I mean, this, to me, I think, is the fundamental question for America, even deeper, and while not immediately more important, in the long run, more important than how do you get out of this economic crisis that we're in.

If we go back to our old ways, we'll be in another economic crisis soon enough.

Chairman Volcker. Well, I sit here and I listen to you and the thought that comes to mind, is, you put the point that I was trying to put, quite eloquently, and the reason you're a Senator and I'm not, is that you can put it more eloquently and understandably than I can.

But you have identified——

Vice Chairman Schumer. Thank you. Out of the more simple minds, who knows?

Chairman Volcker. Not at all. At this level, it is a simple problem which needs to be understood.

Now, part of getting back to a sustainable trend and equilibrium, is simply having gone through this horrible experience, I think people, for a while, anyway——

Vice Chairman Schumer. For awhile.

Chairman Volcker.—will not return to where they were. In fact, the dangers we discussed a little bit earlier, in one context, you may swing too far, and we probably will swing too far for awhile, and we've got to get back into something sustainable.

The other stuff is—it's not just window dressing; it's important, but what protections can we build into the system, when those animal spirits become a little bit too buoyant in the future?

I think there are protections we can build in, and this is the time we ought to do it, while the memory is very fresh. Now, I say that this is the time, but I don't want to do it next month, as I said; I want to take a little time to think about it.

But that is the aim of this whole reform effort. How do we develop a free and open financial system, but nonetheless one that more effectively puts the brakes on in a timely way, which we obviously missed this time around.

Vice Chairman Schumer. Do you have any more specific thoughts on some of the things we ought to do?

Chairman Volcker. Well, I——

Vice Chairman Schumer. And I may have missed them, and if I——

Chairman Volcker. No, but there are so many, but what I——

Vice Chairman Schumer. Give us three of the most important.

Chairman Volcker. Yeah, well, my personal philosophy, which is reflected in this report that the G–30 put out, is, banks ought to go back into the banking business.

That maybe is a very old fashioned idea, but I think we ought to have a core—recent events show how dependent we are on banks as kind of custodians of they system, keepers of the system, and let's not get the distracted by the glamour of speculating in the capital markets, and so they go back to banking.

Interestingly, Citibank seems to be saying that.

Vice Chairman Schumer. Yes.

Chairman Volcker. That they now realize they went off in some area of Wonderland, and they want to go back to the basics, and they've got a great franchise in commercial banking.

So I would like to see that put into the system pretty firmly. We have a lot of room for innovation and flexibility, outside the banking system, but let's keep the core of it solid, active, competitive, and I think that would help in terms of what you're talking about.

Make those banks self-reliant on their own credit appraisal, instead of blaming it all on Standard and Poor's and Moody's or whatever. That's the cultural change that's necessary.

Now, there are a lot of things. What do we do about the credit rating agencies?

We talked about accounting, we talked about, you know, some of the plumbing of the system.

Vice Chairman Schumer. What about things like—and my time is up, but leverage?

Any limits on leverage?

Chairman Volcker. Well, we certainly think those banks are going to be regulated, and leverage would be one area where that would show up. I also think we've got a leverage problem outside the banking system, when you get the hedge funds and maybe equity funds. Some of those have gotten pretty far and wild, too, and may need some leverage requirements there and capital requirements there.

Vice Chairman Schumer. Right. Thank you, Madam Chair.

Chair Maloney. The gentleman's time has expired. Some of the Senators indicating that they were voting and wanted to return, so if the Chairman would allow us, we could go to another set of questions. Do you have the time?

Chairman Volcker. Yes.

Chair Maloney. I'd like to follow up on Senator Schumer's question on the bank of the future, and how do you see the bank of the future, given the fact that we are part of a world economy and have to be part of their international banking standards, and do you think that the European style of universal banks that are mixing banking and commerce, that are the big megabanks, will become the dominant model, or do you think it will be more like Citibank, our original megabank, which has sold off brokerage and insurance and is now back to Citibank with a more focused attention on commercial banking?

And how do you see the bank of the future, and do you think we need to regulate that to make that happen, and could you just elaborate further on the bank of the future in America and internationally?

Chairman Volcker. Well, you raise the phrase, "universal bank," which means different things to different people. If "universal bank" means what you described, that they can also have commercial—be part of a commercial firm, and operate throughout the capital markets and be pretty free to do pretty much anything, that's not what I'm talking about.

I'm talking about more going back something like the traditional commercial banks.

I'm not talking about going back and putting on Glass–Stiegel. I think at this stage, the ability of a commercial bank to do underwriting for its clients and to give advice, is not an unreasonable activity, and they should be able to do that.

The distinction I make, is, are they serving the customer or not?

Are they playing in the market, speculating in the market, transacting in the market, in a kind of impersonal market, where the particular person they're transacting with, doesn't mean much; it's just a transaction, it's not a customer relationship?

The banks ought to be devoted to their customer relationships, primarily, and then the other people can go and do their thing in the capital markets.

If you combine the two, they become—they're both big and diversified to the extent they're doing all these capital market activities at the same time they're doing a more traditional banking business. They are so hard to manage, nobody's been very successful at managing them.

And they are filled with conflicts of interest, and I want to reduce the conflicts of interest and I would like to make it more manageable.

Chair Maloney. Thank you very much. Congressman Burgess?

Representative Burgess. Thank you. Chairman, Senate Majority Leader Harry Reid recently said that the things are being turned around and we're getting very close to stabilizing the banking industry. Do you think that was an accurate assessment?

Chairman Volcker. Who said that?

Representative Burgess. Harry Reid, the Senate Majority Leader, Harry Reid.

Chairman Volcker. Well, I think how close we are to stabilizing the banking system, will turn on things that are happening in the next few weeks, perhaps. You know that the Treasury made a proposal yesterday, which is a step in that direction.

But we did a lot of talking about how to take the bad assets out of the banking system, and I think we need to take some steps there, before we say that we're really on track toward stabilizing the banking system.

Representative Burgess. Some of the discussion we've had this morning, has centered around the amount of debt that the country is taking on. A couple of weeks ago, I took a trip down to the Bureau of Public Debt.

I didn't even know it existed. I watched the auction of three-year Treasury Bills, and I think there were $32 billion worth of Bills that were sold in about 30 minutes that afternoon.

It was certainly startling revelation when you realize that our paper is being sold all over the world. I guess the good news is that it's still selling and that the interest rate is reasonable.

But, recently, our Secretary of State Hillary Clinton, visited China and asked the Chinese to continue investing in United States Treasury securities. I think we had another story from the Financial Times, a couple of weeks ago, where one of the Chinese ministers said, we don't really like you, but we have to keep buying your Treasuries, because that's safest place to go.

So are we on kind of a path where, just like in the Cold War, we were worried about mutually-assured destruction, the Chinese still have to buy our Treasuries and we still have to sell them on the world market?

Chairman Volcker. Well, the signs that you are—the anecdotes that you are repeating here, are a sign of a stressed financial system. We shouldn't have to have a Secretary of State asking people to buy Treasury securities; we want people buying them because they want to buy them, not because of some political quid pro quo.

And to the extent we are extended, it is a sign that we are stressed and we ought to take that as a warning and reinforce what we've been saying this morning about basic policies that have to be followed to get rid of some of this debt or limit some of this debt and get the banks back on a solid footing, so that people are lined up to buy Treasury securities, because they continue to think it's a best bet.

Representative Burgess. Would that include a serious reassessment of the amount of federal spending that we're undertaking?

Chairman Volcker. Yes, without question, that is an important symptom that people are looking at. They understand that we're in exceptional circumstances now that takes some spending. We need a stimulus program, we need all this money to help the banks and other institutions.

Dr. Burgess please show us how we can, over a three-, four-, five-year period, get back into a sustainable budgetary position with a reasonable flow of taxes.

That's a great challenge for President Obama. Clearly, he recognizes it, and that's why he called this meeting the other day.

But to demonstrate it, to make it fully credible, you know, some action has to be taken. I would like to see some attack on one element over this, over a long period of time, over years, which is Social Security, which has been sitting around. I think it is a solvable problem.

If we got at it, I think that would be reassuring. That's just one element that people worry about.

But there are others, and we ought to have a good review of federal spending and get rid of the programs we don't need anymore. But there are a lot of things in civilian programs and certainly in the Defense Department, that probably deserve a good house-cleaning.

Representative Burgess. Thank you.

Vice Chairman Schumer [presiding]. Mr. Snyder?

Mr. Snyder. Thank you, Mr. Chairman. Chairman Volcker, I wanted to ask a two-part question, and this is my only questions, because I'm going to have to run to go vote.

You mentioned the worldwide nature of this problem and the challenges that we have. We have examples of large economies around the world, that are not doing well right now, that are export-driven, and exports have dropped off dramatically. Japan comes to mind.

Another—in contrast, India, which has, obviously, a large economy, a lot of their economic growth has been driven by their huge domestic market, and they obviously are having some dropoff, too, perhaps not as—certainly not as dramatic as other nations.

I think the United States is somewhere in the middle of that. We have both a big domestic market, but we're also very export-driven.

I'd like you to comment on how the solutions may impact differently, a domestic-driven, versus export-driven economy, and then any thoughts you may have about—there are some members of Congress now that are advocating that this is the time to rewrite trade agreements and probably not in their words, but, I would say, become more protectionist. What are you thoughts about that?

Chairman Volcker. On the first question about export-driven, as compared to more domestic-driven economies, I think, as a broad generalization, the globalization of finance and economics, has led to more exports and more imports. The more dependent you are on exports, the nature of this particular economic crisis is you're in more trouble than those countries that aren't so dependent upon exports. We see that over and over again. India is one major example, as you cited of less export dependence.

I do not think, by the nature of this problem, you're going to get anyplace by putting on trade restrictions. I keep saying this is an international problem and everything we do, reflects on others and what they do, reflects on us.

Trying to get out of this, by an individual country cutting down on imports, you're going to find your exports are going to be damaged, directly or indirectly, too, and the temptation is to do that, but I don't think you're going to make much progress, and it's going to have very strong inflammatory political repercussions as well.

So, I would urge the Congress to be very careful about putting on import restrictions. It's much harder now than it used to be. It's much more troublesome to put on the restrictions, simply because the world economy is so much more integrated.

There isn't much we produce in the United States that doesn't depend on imports at some place along the line, and vice versa; our exports depend upon a variety of imports. So it's a very—I don't like to think of it as being fragile, ordinarily it's not fragile, but it's a very interconnected world that is very hard to improve by trying to jump in and put restrictions on exports of imports, generally, or even in particular industries.

Mr. Snyder. Thank you, Mr. Chairman.

The Chairman [presiding]. I've returned, Chairman Volcker. Senator Bennett?

Senator Bennett. Thank you very much. Chairman Volcker, you've touched on this a little bit, but let's return to it.

We will get out of this and what do we want as our regulatory framework, when we do?

As I understand Secretary Paulson's template that he laid down, there were three primary goals: One was the stability of the structural viability of the system as a whole.

The second one was the safety and soundness of individual banks, and the third one was the transparency and efficiency of markets. And, moving next, the assumption is, the primary responsibility of the first, would fall to the Fed, the second to the FDIC, and the third, to the SEC.

Now, that's easy to describe in a single paragraph. The devil is not only in the details, but the details are devilish.

So would you address that whole question?

Do you agree that those are the three areas we should start trying to fill, and then, to the degree that you can, from your own experience, the suitability of the Fed, the FDIC and the SEC, or if there is another regulatory regime, in your view, that might be created to deal with this, or if some of the other regulatory structure that might disappear, if we went to those three big ones, that you think would be a mistake and that they should be saved?

Just kind of range over this whole subject and visit it with us, if you would.

Chairman Volcker. It's a very relevant question, and I must say, a very unfair question, Senator. I've been trying to avoid pronouncing on that particular subject. We wrote a whole report that evaded those issues, but let me give you some comments.

I am rather attracted by Secretary Paulson's broad philosophy here, although it was not very clear, deliberately, as to how you would apply it in practice. I describe it maybe slightly differently than you do.

You put the third category as transparency, and that's part of it. I think of that as a variety of what I would call business practices—the Truth in Lending rules and Truth in Mortgages that the Federal Reserve has, all the traditional concerns of the SEC, the CFTC, transparency.

You know, one thing that people comment on, is these big CDOs that you referred to earlier, are sold in the market like a security, but they're not subject to the normal security laws.

So that is one area. The safety and soundness thing, is the other area, and I think there's something to be said by that being conducted by a different agency, rather than all one agency. They're all mixed up and jumbled up now.

The SEC, I think it's fair to say, has not done a very good job on the safety and soundness side, but that hasn't been their bag over the years, and they like to concentrate on the other side.

And I don't know that the banking agencies have done as good a job as they can do on what I call business practices.

Where you fit the systemic regulator in that picture, is not so clear. I understand the concept, I understand the need, but it's one of the reasons why I haven't wanted to put out my own plan or thought, because I think there are different ways you can do it, and I think we ought to have some debate on how best to do it.

And some of it, at least, gets involved, I think, in international considerations, so we want to work with other countries on it. So I'm not ready to reveal my secret, inward thoughts on how that might look in the end, but I do think that framework is an interesting way to approach it.

Senator Bennett. I think it's where we start, but, clearly, we need all of the kinds of details, and I'm delighted that you're willing to think about it.

Chairman Volcker. What I would like to do, you know, I really think I'm a little afraid the Congress will go ahead and legislate on that, without thinking through what kind of a system they want, and I'd rather have it go the other way, that we reach some consensus on what kind of a system we should have, and then this is the way we're going to regulate it.

Senator Bennett. Thank you.

Senator Klobuchar. Senator Bennett, since you asked such a stellar question, if you want to do one more, it's fine, then I'll go ahead.

Senator Bennett. Since you just arrived, you go ahead.

Senator Klobuchar. Okay, all right. Well, Chairman Volcker, I was listening with great interest yesterday when the President outlined his principles and what he wants to get done, and then to your answer about doing this comprehensive—I don't want to put words in your mouth, but you would prefer to have sort of the regulatory system set up first, and then you look at how you regulate it.

Chairman Volcker. Right.

Senator Klobuchar. Okay.

Chairman Volcker. I would not call it the regulatory system, but the financial system.

Senator Klobuchar. Right, right, the financial system.

Chairman Volcker. Right, exactly, yes.

Senator Klobuchar. So do you think one financial institution should be taking the lead in developing and implementing this new regulatory framework, or should the oversight be distributed among agencies, or how would you most like it to look?

Chairman Volcker. I'm going to give an advertisement here for the Group of 30. We issued a report on that subject without a recommendation, earlier. We're just describing what different countries do, and it is very different.

One approach is putting everything in one agency, and the British are the exemplars of that, and that, for awhile, was considered the direction in which to go. That was the preferred direction.

The shine has been taken off that a bit, given the problems that the British have had, and, particularly, the problems they had in coordinating a response to the crisis.

The other possible way, is more along the lines that Secretary Paulson proposed; have a separate safety and soundness, prudential regulator for everybody, and a separate regulator, SEC, CFTC-type for what I call business practices.

And there are several countries that have adopted that. The American system is by far the messiest; it's the biggest; we've got more agencies involved with conflicting and overlapping responsibilities than anybody else.

I used to think that was something of a strength. I still think so. It makes life very difficult at times, but there is some point and a little competition among agencies, so that they don't become overbearing.

There is a problem, if you have one agency, even on the prudential side, should that be the Federal Reserve?

This is why I don't want to reach a judgment. If it's the Federal Reserve, you've got a very different Federal Reserve than we've had historically, where the focus has been on monetary policy and, above all else, protecting its independence and so forth.

Well, it's a little different, if they're going to have thousands and thousands of bank examiners crawling over all financial institutions around the United States, and I'm not sure we want that.

That's why I'm reluctant to give the answer to Senator Bennett at this point, but those are the issues, we should talk about it, and you arrive at a different answer.

I'm just repeating myself, but you arrive at a different answer, depending upon how you think the financial system should look.

Senator Klobuchar. Right, and I completely understand this idea of taking our time to decide how we want it to look, and then how it should be regulated.

But one of the issues that I confront, is that our financial institutions, the confidence issue and the trust in them, is eroding, and some of it, as I pointed out in my brief, one-minute opening there, is unwarranted. You know, some of our small banks are doing well, our credit unions.

We have some healthy large banks out there, as well, and they're actually being brought down by this uncertainty right now, whether it's about the stress test or about the way things are going to be regulated, and I'm just curious about that urgency of making things clear, versus trying to look at this so comprehensively.

How can we, as we look at this comprehensively and say it takes awhile to set up this new regulatory system, how can we in the meantime, try to bring back that confidence in at least our healthy banks and healthy credit unions?

Chairman Volcker. Well, again, you know, I'm being maybe totally unrealistic, but when we take these particular actions of saving particular institutions, recapitalizing particular institutions, or guaranteeing particular institutions, let's be careful in doing that, that we're not doing things that we're going to be sorry about in the future.

Now, one area that just happens to have been a longtime hobby horse of mine, I don't want to combine banks with commercial firms. Which is longstanding American policy.

There are some exceptions, but they are relatively small exceptions. Now, the temptation is—and I think we've reached that a little bit now—you take emergency action that seemed to be nice to permit some institutions to become part of the Federal Reserve or part of the safety net, even though they are connected with commercial institutions.

And there are non-banking institutions that are very heavily engaged in commercial operations, that apparently would like to control some banks, and they say, we've got money, so let us do it.

Well, that's great, but we're violating——

Senator Klobuchar. Yes.

Chairman Volcker [continuing]. The way we want the system to develop over time.

Senator Klobuchar. And that's why I'm so concerned about some of the stock going down in some of these healthier banks, that that will be the end result, if we don't clarify what the rules are and act somewhat quickly to get this done.

Chairman Volcker. Now, we can qualify those rules for the moment, without deciding who the regulator is going to be.

Senator Klobuchar. That's true, through this stress test and getting it done quickly, so that would be, to characterize what you're saying, to get that done, so we can sort of set some sanity in the market.

Chairman Volcker. For the time being, we have to live with the institutions we have, and we've got banking. They're working together, I think, pretty well, that's my impression.

Senator Klobuchar. Well, the other piece of this, which is an easy answer, is that you put different people in charge, and sometimes things can improve, you put bigger emphasis on—and this is, again, in the meantime, because I do think we have to make structural changes, but the whole Madoff scandal, the fact that that wasn't caught, it's a combination of structure, but sometimes it can be other people's emphasis, who are in charge of the agencies.

Chairman Volcker. I think that's right; it's a failure of supervision that had nothing to do with whether you had a unified regulator or a lot of separate regulators, and there, the responsibility, the agency involved, is pretty clear.

In other cases of lapses, it might be a different agency, but we're not going to cure that by moving around the pieces on the chess board.

Senator Klobuchar. I wanted to just go back to—I'm going to ask maybe one or two more. The Group of 30's report for laying out a financial framework for financial stability that you chaired, the report included a conclusion that a few banks will still need to be so large that their failure would pose a systemic risk, or in other words, they would be too big to fail.

And while the report calls for elevated oversight and regulation of the big banks, you believe it is an acceptable level of risk, to have institutions operating, whose singular failure can trigger this kind of collapse that we were so fearful of?

Chairman Volcker. Well, we want to have a system that minimizes the threat of collapse, so you don't have to take these extraordinary measures. But it means they're going to have, I think, an extraordinary degree of supervision.

And the danger will be that supervision will become too heavy-handed, and that those institutions won't be able to compete effectively. Now, this is one reason why we want to get some consensus internationally.

There are two things you can accomplish internationally: You can get some consensus, I hope and believe, on how you supervise these mega-institutions, because they are operating all over the world.

Senator Klobuchar. Yes, they're operating internationally.

Chairman Volcker. And also, I think you now have some possibility of doing something that hasn't been possible, of dealing with the tax havens and the regulatory havens. The Europeans are pretty hot on that, and we ought to be pretty hot on it, and between the us, I think we can do something about that.

Senator Klobuchar. Exactly. So those are two areas you think we could accomplish something internationally?

Chairman Volcker. Right.

Senator Klobuchar. How about the credit rating agencies and what happened with them here when they were rating things as gold, and then the next day, they went under; what do you think we could do about that?

Chairman Volcker. You've got Mr. Altman testifying here? [Laughter.]

Chairman Volcker. I'm going to turn that question over to him.

Senator Klobuchar. Okay.

Chairman Volcker. You know, it's a very difficult area, and I've been scratching my head. I think it's fair to say that that is one area where our recommendations in this report, were rather obscure, because we didn't come to any very definite conclusion as to how to deal with that.

There are obviously things you can do in the realm of transparency and so forth, but I don't think there's an easy answer, by saying you have a different model for how they're paid. Maybe you'd want to do that, but it's not easy.

There are a number of approaches that can be taken. Do we want more competition?

I think the answer is probably yes. Do we want to facilitate more credit rating agencies of a different type, that are paid by the lenders, rather than the borrowers?

I think the answer to that is yes, too, but I'm not sure it's viable, economically, so I am demonstrating that I don't have settled views on this area.

Senator Klobuchar. You know, early on in—and this will be my last question here, and then I think we're going to recess for the Chair to return, and she'll be here shortly.

But when I spoke, I talked about these small banks that have been, for the most part, staying out of these high-flying deals, and then you have some of the large banks that are, by all accounts, much healthier than some of the other banks, that not all banks are the same, not all banks made the same kind of decisions.

Do you envision that we could have a situation where small banks are doing fine, you've got some of the large banks that can rely on the private capital; that maybe they'd take some of the TARP funding in the past, because they were asked to, but that's not necessarily they did it because the other ones or they were told to, but they basically can stand on their own legs, while you have certain of these institutions, a select few, that are either under temporary receivership or are just getting more of these funds on loan—is that possible to imagine there could be differences between these large banks?

Chairman Volcker. Well, I don't know about the difference between large banks, but I think there are differences between the small banks and the large banks, in the sense that the FDIC has kind of established procedures that work pretty well for dealing with small banks.

When it gets to be a very big bank, it kind of taxes the resources and methods of the FDIC, and so they need, to some degree, different treatment, and I think that's what will emerge here.

Senator Klobuchar. Right, and I understand that. I'm just looking at, as we go forward with this stress test, as the Administration does, I'm one to believe, just knowing some of the banks in our state, that there are differences between the large banks, you know.

There are banks that didn't have the pavement crumple under them, and go to Washington with a tin cup, when all of this happened, and then there are other banks that made some really bad decisions that there may be a good reason to decide to keep them going, because they're too big to fail, as was pointed out before.

And I just would like some acknowledgement that there are differences between these large banks——

Chairman Volcker. Well, you're certainly right about that, but just in the small banks, an obvious point, but when the small banks get in trouble, it's much easier to merge a small bank, than it is to merge a big bank.

Senator Klobuchar [presiding]. That's for sure. All right, very good. Well, thank you, Chairman Volcker.

We're going to temporarily recess this hearing, unless you have more questions or comments, Senator Bennett?

[No response.]

Senator Klobuchar. We'll recess until the Chairman returns. Thank you very much. The hearing is temporarily recessed.

[Recess.]

Chair Maloney. I'd like to convene the second panel. I apologize; we had votes, but that's where many of the members are. They are on their way back. I see Congressman Hinchey arriving.

I want to thank very much, the distinguished members of the second panel. Roger Altman has had an outstanding career in both the public and private sector.

He served two tours of duty in the U.S. Treasury Department, initially serving President Carter as Assistant Secretary for Domestic Finance, and later serving President Clinton as Deputy Secretary during a time of great economic positive actions.

Since 1996, Mr. Altman has served as Chairman and Chief Executive Officer of Evercore Partners, which is now the most active investment banking boutique in the world, with offices in the U.S., Europe, and Latin America.

Previously, he was Vice Chairman of the Blackstone Group, and responsible for its investment banking business, and his initial Wall Street career involved Lehman Brothers, where he eventually became co-head of investment banking, a member of the firm's Management Committee, and of its Board of Directors.

He is a member of the Council on Foreign Relations. He received an AB from Georgetown University and an MBA from the University of Chicago. Welcome.

Dr. Adam Posen is Deputy Director of the Peterson Institute for International Economics in Washington, D.C. where he has been a Senior Fellow since 1997.

His research focuses on macroeconomics, policy, and performance, European and Japanese political economy, and central banking issues. He is a widely-cited expert on monetary policy.

He has been a visiting scholar at central banks worldwide, including, on multiple occasions, at the Federal Reserve Board and the European Central Bank.

From 1994 to 1997, he was an economist at the Federal Reserve Bank of New York, where he advised senior management on monetary strategies, the G–7 economic outlook, and European monetary unification.

Dr. Posen received his PhD and his AB from Harvard University, where he was a National Science Foundation Graduate Fellow.

Dr. Joseph Mason is the Herman Moyse, Jr. Louisiana Bankers Association Chair of Banking at School of Business of the Louisiana State University, Senior Fellow at the Wharton School, and a financial industry and monetary policy consultant.

Dr. Mason formerly taught at Georgetown University and at Drexel University, and before that, was a financial economist at the Office of the Comptroller of the Currency here in Washington, D.C.

Dr. Mason's research primarily investigates liquidity in thinly-traded assets and illiquid market conditions.

I welcome all the panelists and recognize Mr. Altman. Thank you all for coming.

STATEMENT OF THE HONORABLE ROGER C. ALTMAN, CHAIRMAN AND CEO, EVERCORE PARTNERS, INC., NEW YORK, NY

Mr. Altman. Thank you, Madam Chair, and thank you for inviting me to testify this morning. I'm going to try to make five simple points, which essentially summarize my testimony and keep my remarks brief:

First, one point about the origins of this financial crisis: One reads constantly that the housing collapse and the subprime mortgage crisis were the cause of this problem, and I don't think that's correct.

I think those were a symptom, and, rather, the combination of extremely low interest rates and extremely high levels of liquidity, actually were the root cause.

We had extremely low interest rates following 9/11 and the subsequent recession, with the Federal Funds Rate remaining around one percent for three years.

We had enormous liquidity on account of the so-called global savings glut, to quote Chairman Bernanke, which particularly built up in certain developing countries like China, Singapore, and the Persian Gulf oil states, and the combination of those two, if allowed to continue long enough, always is lethal, and here, also was lethal.

So the point is that the authorities will have to be much more vigilant in the future, when this combination of extremely low interest rates for a long period of time, and extremely high liquidity for a long period of time, again presents itself, because that is at the bottom of all of this.

My second point is that this financial collapse has ushered in the first balance sheet-driven recession in 60 years. Unfortunately, the nature of that means that we are consigned to a sub-normal recovery. It is, unfortunately, axiomatic.

It's a balance sheet-driven recession in the sense that American households lost so far, about a quarter of their net worth from the peak of only less than two years ago, in other words, around $13 trillion.

It's a balance sheet-driven recession, because we all know what's happened to the balance sheets in the financial sector of our economy. And even the federal balance sheet, after this interim period of stimulus and monetary ease, will have to be adjusted towards contraction, in order to avoid causing unease amidst the public, amidst the world financial markets, the foreign exchange markets, and so forth.

So, if you ask yourself how long will it take for the consumer's balance sheet to be made healthy again, for the financial sector's balance sheet to be become healthy again, as it relates to normal lending, the answer, unfortunately, is a fairly long period of time, and not consistent with any recovery, other than something approaching a U-shaped recovery.

The third point, on the credit crisis itself, I want to echo a small point that Chairman Volcker made, which is, there is some good news. If you divide the credit markets into two parts, just to oversimplify it, and say one is the enormous public credit markets, which, of course, trade every day and so forth, and the other is the banking system, the public credit markets have show some signs of thaw.

There is some good news there. The commercial paper market has struggled to begin to function again, the so-called high-grade corporate market, the same, some of the key spreads in the short-term public credit markets have narrowed a lot.

And I think the Fed is particularly to be commended for beginning to thaw out that market. The banking system, on the other hand, is going to remain incapacitated for some time, surely through 2009, as we all know.

The fourth point, the federal policy response so far, I really think it has been close to heroic. Of course, it isn't perfect, and if you gave the authorities a chance to redo their decisions on Lehman Brothers, on AIG, perhaps on the original rollout of the TARP, I think they might do those differently, but, in general, I think the federal response has been quick, large, and rather creative.

After all, $9 trillion of liquidity and guarantees, have been provided to the credit markets through a whole host of instruments, as you know, and I do believe that history will judge us rather well, even though it will take quite awhile to work this out, as it did judge us well, in retrospect, on the working out of the savings and loan crisis 20 years ago.

Finally, on the Obama initiatives themselves, they've only been in office for 38 days, I believe, and they've rolled out four of the biggest initiatives we've ever seen. Of course, the stimulus program, we all know about it, but if you step way back, this was passed very quickly and it does meet all the necessary tests of speed, size, temporary and targeted.

The improvement that they have made in the TARP, which they are now calling the Capital Assistance Program, I think are important, such the advent of the stress test, the requirement for specific lending targets, the limits on buybacks, dividends, acquisitions, and compensation.

Then the core of this is the public/private partnership. We don't have the details yet, but this is an important idea; it's a rather courageous idea, Madam Chair, because it will not be a popular one.

Why won't it be popular? Because it probably, as well see in the details, involves the Federal Reserve making term loans to investors like hedge funds and private equity firms, in order to try to enable them to purchase distressed assets or toxic assets from the institutions that have too many of them.

That's a difficult idea, but it's the right idea. And I might say that with all the talk about nationalization, I'm happy to see that it seems to be cooling down a little bit, because that is not a particularly attractive idea.

Of course, there are cataclysmic circumstances under which it might be the very last resort, but, fundamentally, our government is not equipped to manage institutions of this size. Nationalization would cause the weak to get weaker, because business customers and talent, among other things, would be hard to retain.

It would take, I think, a lot longer than people say, to re-privatize them. There would be a temptation to conflate policy goals with fixing these institutions, which would delay their reprivatization.

A Swedish example is not comparable, and, finally, you don't need to nationalize the institutions to change the managements or boards of directors.

I'll stop there, in an effort to keep it short, but those are the main points I would like to make this morning.

[The prepared statement of Roger C. Altman appears in the Submissions for the Record on page 59.]

Chair Maloney. Thank you for your testimony and your public service. Dr. Posen?

STATEMENT OF DR. ADAM S. POSEN, DEPUTY DIRECTOR, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Mr. Posen. Thank you, Chairwoman Maloney, for the invitation. It's a great honor to be able to go on after Paul Volcker.

I think I have to have a much more narrow focus, which will end up putting me much more in opposition with the last two points of the previous testimony, and which I hope will be useful to the Committee. And the reason I go on this narrow focus, is partly because the staff asked me to, but partly because I think the previous discussion ignores what's really going on, which is that we are in the midst of a real banking crisis and talking about what will happen in the future, some years down the road or even some months down the road, is insufficient.

And it is costing our people national wealth and jobs and security right now, and it is within the power of both Congress and the Administration, to stop it right now, and there are proven ways to do this.

The good news is that Sweden is relevant, Japan is relevant, the savings and loan crisis is relevant. There's a core dynamic to every banking crisis, and we know what that dynamic is and we know how to respond to it.

So let me try to recap for you, what those aspects are, and make some notes on the places where I think the Obama Administration's proposals so far do and do not live up to best practice.

The first point is, we do have to recognize that the money is gone from the banking system, and right now, we're in a very strange private/public hybrid state.

And in this situation, Paul Volcker spoke about how much government intervention there already is. We can't pretend that there's a choice between government not knowing how to manage institutions, government already is backing and guaranteeing these institutions to an extraordinary degree.

And what we know from the experience with Fannie and Freddie, among many other countries and many other times, is, these kinds of public/private hybrids are worse than the institutions that are cleanly public or cleanly private.

Basically, the managers and shareholders who remain in control, play games with the public's money. If they win, they retain the profits and they retain their jobs and they retain their shares, and if they lose, the losses go to the taxpayer.

So when the Secretary of the Treasury says these banks will then have six months after another two months of stress testing to get new capital, they are putting us all at risk for an extended period and we are likely to see much larger losses, as well as a drag on the economy, as well as an ongoing risk of a collapse, unplanned, by one of these institutions.

These are half measures, and we should not settle for that.

The second point is, therefore, we should take what is being called the "stress test," and without hesitation, go through the banking system and mercilessly decide who shall and who shall die.

Here, I agree very much with the written testimony of Mr. Altman. There's a standard way to triage banks. You basically say, there are some that either have enough capital or very close to it; you give them a little pat on the back and you send them on their way, and they generally get a boost from being shown to be better than the others.

There are some that are small, short of capital, but clearly viable, with relatively clean bad assets. You sell those off quickly, you may merge this company with another one, and that's doable.

The third category are the banks that are truly insolvent, and here, there's two subcategories: There are small ones, like Indy Mac, you close them.

There's large ones that are systemically important. Those are the ones that are, of course, the problem, and those are the only banks that we should be talking about nationalization.

Now, what do we mean by "nationalization"? As has been said, it's a red-flag word, people get very scared of it, we can go into that in the discussion.

Essentially, it means the government, on behalf of the taxpayers, takes control of the voting rights and the profits, and probably replaces many of the current board and top management.

And the reason you do this, is the same logic as when you do a merger or acquisition in the private sector. You have a company to restructure and you're putting up the capital, you want control and you want the upside on the other end. The American taxpayer deserves no less.

It is actually relatively feasible to do that, and you can talk about temporary nationalization. No one in their right mind, wants governments controlling banks for a length of time. I've been criticizing the Europeans about this for a long time, but it also is not so unprecedented, and if we can determine the world price for corn, because of ethanol, if we can bail out GM and Chrysler, we can manage to deal with a couple of banks.

Finally, we should be moving forward with an RTC model, and this actually is the other point where I must differ with Mr. Altman and my friends in the Administration. This attempt to create this complex private/public, non-bad, aggregator, pseudo-bank-bank to get through the banking system, problems and bad assets, is too clever, by half.

I appreciate the motivations. They want to make sure there's less taxpayer money up front, in part, because they don't want to go to you all, and they want to get what they call "price discovery," which is, accurately, get some basis for pricing these assets.

It, however, will not work. They are not fundamentally changing the nature of any of these assets, if they do not own them. So the only value of these assets, the change, is whatever subsidy the government transfers by guarantees to these private investors.

Therefore, you're basically subsidizing them to take the stuff. To whatever degree there is limited price discovery, there will be what economists call "lemons problem;" the private actors will buy the good stuff and they will leave the taxpayer and the government with the bad stuff, which then will have less of an up side, and we will have given away the up side on the good stuff.

There is also an additional advantage, if we keep it as a wholly-owned government RTC, because there are all these sliced-and-diced securitized mortgages and other things out there, and that is the real reason many of these securities are toxic, because you're so removed and it's un-transparent from those, and only the government, by buying a majority or supermajority share of the outstanding assets in these various classes, can then go through the laborious work of putting them back together.

The analogy is, when the EPA buys a Superfund site. That real estate is useless to people, they can't live on it, but if you send in the right people and detoxify it, that real estate is then worth something again.

But you actually have to do the cleanup; you can't say, I'm going to give you a mortgage on this toxic waste dump and you're going to want to live there. That is effectively what is being proposed at present, with this private/partnership scheme, which forgoes much else.

I will skip over a remark about the size of banks. That was raised earlier. I'm happy to talk about this.

I would just say one more thing in terms of urgency. It is clear that whatever the good intentions of the Obama Administration are, they are not proceeding with the level of urgency regarding the banking crisis that I think we need.

Essentially, it can be done within a couple of years; it can be done if we start now, probably mostly within 18 months. The fact is, we have 18 months till the stimulus package runs out.

The only way the U.S. is different from all these other countries' banking crises, is, we're able to borrow money to offset the misery of doing a bank cleanup. The banking crisis is the same, and if we don't get the banking crisis fixed before the stimulus runs out, we're just going to be more miserable at the other end. Thank you very much for the time today.

[The prepared statement of Adam S. Posen appears in the Submissions for the Record on page 62.]

Chair Maloney. Thank you very much. Dr. Mason?

STATEMENT OF DR. JOSEPH MASON, HERMAN MOYSE, Jr./LOUISIANA BANKERS ASSOCIATION ENDOWED PROFESSOR OF FINANCE, LOUISIANA STATE UNIVERSITY, AND SENIOR FELLOW, THE WHARTON SCHOOL, BERWYN, PA

Dr. Mason. Thank you, Chairman Maloney, Ranking Member Brownback, Members of the Committee.

My testimony outlines three primary suggestions for short- and long-term change. The macroeconomic understanding of financial crises that we're dealing with here, is that they don't cause recessions, but they prolong and deepen them.

So, until the crisis is resolved, fiscal and monetary policy will merely push on a string. Among the key weaknesses I'm going to discuss, are classic problems like too-big-to-fail, insufficient accounting transparency, and textbook asset market overhang.

The unifying theme of all these, is restoring credibility of the U.S. financial system.

On the subject of too-big-to-fail, the too-big-to-fail doctrine has yet to be resolved for nearly 20 years now. The latest incarnation has been justified by what we're now calling systemic importance of some institutions over others.

Systemic importance, however, is a specious and potentially dangerous concept. In fact, the systemic nature of today's problem lies only in the degree to which large banks managed to enter business arrangements that they themselves and regulators were reluctant to monitor.

Merely ignoring risk, does not make it justifiably systemic. In fact, the systemic risk debate is distracting from the real issue.

Too-big-to-fail hinders economic growth when it embeds value-destroying lending in our financial system.

There's a lot of talk about "the banks" lately. There are three classes of banks in the system right now, as Dr. Posen discussed: The insolvent, the marginally solvent, and the solvent.

Insolvent banks, regardless of their purported systemic importance, are value-destroying institutions that need to be closed. If insolvent banks were car companies, they would be relying on worn machinery and ill-trained staff, to produce East German Trabants that break down as soon they leave the production line.

In fact, the loan products these banks created, did break down almost immediately after they were produced, exhibiting early payment defaults and often involved payments and fees that a borrower could not afford.

The mortgage delinquencies we see today, are, therefore, the result of faulty management, bad supervisory systems, faulty proprietary software, and ineffective employee training at these institutions, not mere exogenous economic shocks. The banks that produced those products, are insolvent as a result, and need to be broken up, not supported.

While the economy does need loans to fuel economic growth, it needs high-quality, value-creating loans, that borrowers stand a chance of repaying. Government recapitalization programs with appropriate limits on management and insistence on institutional reform, can possibly benefit marginally-solvent institutions that present the possibility of supporting economic growth by creating, rather than destroying value.

Still, while marginally-capitalized banks can be stabilized, their mere stability will not significantly fuel economic growth. Policy, therefore, needs to focus on relieving the economy of the value-destroying loans produced by the now insolvent banks, financially and operationally restructuring the marginally-solvent banks, and, thirdly, building economic growth upon the lending platforms of value-creating, solvent banks that are still open.

But that leads to the issue of transparency. Who are these solvent banks? We can't tell. Commonly produced, standardized financial ratios, are meaningless in today's markets, and, without information, investors don't know the value of their holdings, they can't sell those holdings, and they can't rationally allocate funds derived from those sales, if they could.

Without funds, firms can't invest in new projects that create economic value, that is, jobs, income, and growth.

Nonetheless, FASB continues to adhere to a policy of reporting a single value for every asset. But in a off-balance-sheet world of contingent claims backed by fuzzy reputational risk and statistically modeled values for Level II and III mark-to-market assets, a single value is not only inadequate for accounting purposes; it's grossly misleading.

Investors want to know the entire exposure to off-balance-sheet items and the range of statistical model values that can be reasonably expected to apply to Level II and III assets, that is, the standard errors of the estimates.

Such information allows investors, including all manner of bank counterparties, to truly stress-test firms' financial characteristics on their own in a transparent way, without being filtered through Treasury's secrecy and interpretation.

That still leaves the problem of market overhang. Asset market overhang is today being perpetuated by a dogmatic policy approach to home ownership and archaic bank regulations that stand in the way of quick recovery.

If we view the housing crisis as merely one of occupancy, rather than ownership, policy solutions are readily at hand. The common understanding of the problem, is that foreclosed homes are dumped on the market at fire sale prices, and those prices push values down in surrounding neighborhoods.

But while focusing on the foreclosure part of the problem, we're missing the important part: the fire sale that pushes down asset prices. Fire sale prices result not because lenders want to sell at a loss, but because they are forced to do so. They do not have the legal ability to manage real estate and that ability could greatly relieve pressures on home pricing.

But even without such pressure, we still have a big hole in the loan servicing market. Loan servicing is a wildly subjective industry. Right now, forthcoming research and news reports are already showing that many companies claiming to be special servicers are really run by the same managers that owned the failed subprime mortgage companies, entering the business to fleece borrowers further and collect the thousand dollars per head fee offered under the most recent housing plan.

Even worse, modification frauds have been reported to be proliferating throughout the country, praying on the same uninformed consumer that got the unaffordable subprime loan.

The fact is, servicing quality matters; it's crucial to loan value, and, of course, borrower success in repaying the loan. But the servicing industry needs to be kept in check.

Investors and borrowers alike, are at the mercy of a servicer who's making a judgment call as to whether a mortgage is salvageable or not. Moreover, that judgment call is made with virtually no direct oversight.

So, as regulators are learning, servicer accountability and reporting is woefully inadequate and, unfortunately, absent from the discussion right now. It needs to be paid a great deal of attention.

But in closing, I want to say that it's very fitting today to have Chairman Volcker before us on the first panel. The Chairman presided over a Federal Reserve at a time when we first learned of natural rates in the economy.

We learned then that attempts to push unemployment below natural levels, created perverse economic effects. The recent push to drive home ownership rates to 100 percent, and substitute debt for income, has had similar perverse effects.

As before, the only way out, is to move through the downturn. I only hope we can learn from Chairman Volcker's example, and exhibit the courage to do so. Thank you.

[The prepared statement of Joseph Mason appears in the Submissions for the Record on page 71.]

Chair Maloney. Thank you very much. I thank all of the panelists for your very important testimony.

Mr. Altman, as the former Deputy Secretary of the Treasury during the RTC challenge—and I believe you managed the RTC challenge—could you share with us, some insights between that challenge and the challenge we confront now, any differences, and if you could respond to some of the points that Dr. Posen put forward, that taxpayers may be called upon to assume too much of the loss in the toxic assets, and his particular proposal that is similar to the Sweden approach, and your response to it? Again, thank you very much for your time and for being here.

And thank you for giving us some positive indicators from the private sector. That was very good to hear.

Mr. Altman. The RTC case, first of all, is one we can learn a lot from and probably has not been delved into as much as it should as a guide to what we may be doing now from a public policy point of view.

You may remember, and other Members may remember, that at the time the RTC was the most popular—excuse me, unpopular organization ever created. It was hugely unpopular. Absolutely no one liked it. And it was the object of not just criticism but investigations, and so forth.

Now the conventional wisdom at least is that the U.S. addressed the savings and loan crisis in general, and also through the RTC, swiftly, effectively, and that it is a model for how to address a financial crisis of that type.

I said in my testimony that I think that despite the enormous challenges we face today in the depths of this crisis, I do think that the United States, if you step away back and think of this in broad historical terms, is addressing this crisis swiftly and creatively and that ultimately history will render a similar verdict as it has now done mostly on the S&L crisis.

However, what are the cautionary lessons from the RTC experience? First of all, it took the RTC—and this is partially a response to Dr. Posen's point on a bad bank—it took the RTC, Chairwoman Maloney, a long time to get up and running because that is the nature of things. If someone said to me: Well, how long did it take? And I was not there in the early two or three years. You know the Clinton Administration came into being in 1993 and the RTC was formed some time around 1990. But it took about three years for it to become fully operational. Because it was building a large institution from scratch.

So if we were to go the bad-bank route—and I think it is a close debate; I mean, I want to say that Dr. Posen made good points, it is a close debate as between for example the public/private partnership approach the Administration has put forward and a more aggressive approach towards a so-called bad, or aggregators bank—but if we were to do that, it would take, it would simply take a long time to make that operational.

You would be talking about building an enormous financial institution from absolutely ground zero. It does not mean it is a bad idea, it just means that it is not something that would come into being effectively very quickly.

I think the other point I would make about the RTC is that it was very widely criticized at the time for the first several rounds of auctions where it sold, quote, "bad assets" into the market as it was statutorily charged to do, and some of those who purchased them in the early auctions ended up making a lot of money.

You probably remember that controversy. But in retrospect, was that really a problem? The assets were auctioned. In the early going there were not many buyers because the market for those assets that were so distressed had not developed very well. And so the early buyers who took considerable risk ended up doing very well.

In general I do not think that is a huge problem. And so if we were to set up this public/private partnership and, yes, the nature of it is that the investors will receive preferential financing in order to incentivize them to participate. And if the investors ultimately do well, as long as the ground rules are clear and the restraints are sufficient, I do not think that is something to be feared or to be—or to do everything possible to avoid.

But I would basically say in regard to the points that Dr. Posen made, it is a close argument. If we go the public partnership—public/private partnership route, the taxpayer will have to participate very strongly in the profits. So if this turns out to be, as I believe it will, that the Federal Reserve provides term financing to investors, and those investors or organizations like hedge funds and private equity firms and so forth, the taxpayer will have to be eligible for a high percentage of the profits that those organizations get. That is the only fair way to do it.

I think that is how it would have to be set up, and that is how I would answer Dr. Posen's point on that.

Chair Maloney. Thank you very much.

Congressman Brady.

Representative Brady. Thank you, Madam Chairman.

I do think the RTC looks much better today than it did when it existed. I was in Texas running a Chamber of Commerce. We had many of the banks that failed in the community, and I will tell you the RTC in my view, in real-life, delayed the economic recovery of our communities.

They had no real knowledge of the value of the properties they were holding. They were very slow to respond. We brought purchasers, we brought investors, couldn't get answers for literally, I do not exaggerate, years on properties.

And there was no transparency. It was like a black hole. I do think, having gone through it once, I think if it were to be revived there are some dramatic lessons that we can learn from how it can be applied.

Because the end result was the taxpayers did not lose dollars, and eventually those properties got transferred. But there is a lot to learn from that experience.

I do think—I agree with all of you—the sooner we force these assets, bad assets, to the surface the quicker we are going to get consumer confidence back in the economy.

I really appreciated the testimony from all three witnesses. Dr. Mason, you talked about how existing policy proposals have been all about suppressing information, information about bank conditions, other sources of risk, even about government programs. And you talk about the fact that investors want more. They want more information here, and you talk about investors wanting to know the range of statistical model values.

In other words, investors want to stress-test financial characteristics on their own. They want the ability to determine this value. How do you go about doing that? And rather than having the government apply a stress test and then, do certain actions, you are talking about increasing information dramatically, significantly, so investors can run those stress tests.

How do you do that?

Dr. Mason. Well to get at this, I'll start by saying I testified previously on FASB reform and I made the point there that unlike previous crises the assets that we are dealing with here are structured finance assets. Over the last two years we have learned kind of Securitization 101 which involved the idea that the bank sells loans into a pool, and then the pool funds its purchase of the assets from the bank via securitized bonds.

That is Securitization 101. We need to get to Securitization 102, which is that that sale was never really complete; that there were side agreements. There were contractual agreements, too, but the additional side agreements that could never be contracted to stipulated that, if anything happens adversely to this loan pool's performance, I as the bank will take it back and I'll make it good for investors.

That is incredibly important. Because over the years from the mid–1990s on bank regulators allowed this over and over again in violation of their own regulatory policies. FASB enshrined us in their own rules such that a greater degree of this activity could go on.

So at the end of the day you get a ratings agency who comes in and rates this. And quite rationally they look at it and they say, well, the condition of the loans in this pool doesn't really matter; what matters is whether this bank is going to support it at the end of the day. And since the bank always will because it wants to issue next month, and the month after that, and the month after that, and the month after that, then we can call it whatever we want to: AAA. And this is all just a big farce.

So finally we have come home to the end game in this where the bank does not support it anymore. So now both the bank investors as well as the asset-backed securities' investors want to know, Mr. Bank, how much did you sell? How much do you have out there that people want supported?

If you're not going to be able to sell any more, which banks cannot right now, then how much does your capital support both in your contractual obligations to support these pools, and any additional obligations you have to the government under TARP to increase lending or anything else?

Banks do not have the capital ability to expand. When you live in a world where you make a loan and you sell it out the back door, you do not keep the capital on your balance sheet to make a loan and keep it in the bank. And that is why we are at a standstill right now.

You cannot reasonably expect these banks, when you give them capital to shore them up just to basic solvency, to lend if they cannot push the loan out the back door. The Fed facilities are for secondary market securitizations. There really is no market to sell this into.

If we wanted to talk for an hour, I could give you example after example from securitization history from the early 1990s to the present where we have seen this demonstrated time and again. It is not unknown to the industry.

Representative Brady. Thank you, Madam Chairman.

Dr. Mason. But this is the way the world works.

Chair Maloney. Thank you. Congressman Hinchey.

Mr. Hinchey. Thanks very much. And thank you, gentlemen, for being here and for the very interesting testimony and the comments and responses to questions that you have given. I appreciate it.

It is a very interesting problem that we are dealing with, and one that is very serious and very difficult. Over the course of the last several months there have been some shifting changes in ways in which this needs to be dealt with, and focusing on this wide spread and worsening financial crisis. It is not getting better. It is continually getting worse, as you pointed out.

Last September of course we remember the Bush Administration and Secretary Paulson came in and asked for $700 billion to deal with the banking crisis and thought that, in their expression to the Congress, that that would be a major contribution to taking care of the problem.

But it was not very long after that bailout legislation was passed that they shifted the strategy and started something called the Capital Purchase Program, and several other capital infusion programs.

The effect of that has been very interesting. Over the past few months the Federal Reserve, for example, engaged in huge lending facilities, and over the course of the last year and a half they have expanded the balance sheet from just under—just over, actually, just over $900 billion to now almost $2 trillion.

With the new lending program the Fed announced over the past few months that we are likely to see the assets expand by an additional $1.6 trillion. At the same time we are still afraid that the major banks left standing will continue to become insolvent.

The crisis they are facing affecting credit and credit variously, in various ways, and of course a general way, has a general effect on the economy.

So what we are seeing now is the impact on households and small businesses. They cannot borrow. They cannot borrow, they cannot spend. They are having a direct effect on output, economic output, and obviously an economic effect on employment.

As the incomes of households and firms are going down, and they are continuing to do so, default rates on existing debts are going up, and potential borrowers are becoming less credit worthy.

So we need to really face up to this issue, not just specifically with regard to individual aspects of it but we have got to look at this whole thing very, very carefully. So I am wondering what you might suggest to us is the root cause of the general financial crisis, and what Congress should do to address and solve the crisis that the banks are facing and the impact that the bank crisis is having on the economy generally.

What are the orders of priority perhaps that we should be dealing with?

Mr. Altman. Well, Congressman, I said it in my testimony that I thought the root cause of it was not, as so many people say, the twin housing and mortgage collapse, but rather that that was a symptom, and that the root cause was a combination which I would argue would always be lethal if allowed to continue long enough—and in this case it did—of extremely low interest rates and extremely high levels of liquidity.

Because if you think about it, if you have enormous liquidity which we saw build up in locations like China, Singapore, and the Persian Gulf oil states and then recycled back to the West, particularly the U.S., and that liquidity is facing very low yields because the levels of interest rates were so low given the Federal Reserve's stance, it is like water running downhill. It seeks out higher yields.

And the way you find higher yields is to look for weaker credits, because the weaker the credit the higher the rate that credit has to pay. It is one of the iron laws of finance.

So these giant amounts of money were seeking out weaker credits. Well, they sought them out everywhere but the easiest way to find them was in the mortgage market, which is one of the deepest and most liquid in the world, and of course the weak part of the mortgage market is subprime.

But it was that combination of very low interest rates and high liquidity which drove this crisis through. So housing prices, which had averaged 1.4 percent rates of appreciation for 30 years, because of the huge amounts flowing into the mortgage market which then allowed so many homes to be acquired which might not otherwise have been, rose ultimately to 11 percent. We had an 11 percent increase in home price appreciation at the peak. And of course it was not sustainable, and the rest is history. So that is my view on what the root cause was.

As for how we should address it, I happen to think that in the past year—and particularly the Obama Administration in the past month and a half—is addressing it very, very aggressively. These four steps—the Stimulus Plan, the Adjusted TARP, it's been substantially adjusted; the proposed public/private partnership, and we'll have to see the details on that; and then the attack on the mortgage and housing problem which has been laid out now—represents a very aggressive program. And I think it is a good one.

Is it perfect? No, it is not perfect, but it is a sound and good one which, to lay out in 38 days is a pretty Herculean achievement in my book.

Mr. Hinchey. Well I appreciate what you just said in response to that, and I think that the example that you use in the answer to the question is consistent with what you said in your testimony which I think is very factual and seriously a part of the problem. We have seen it in the past. We see it now.

But we have also seen major manipulations of investment, and falsification of information in the context of bonds, huge ones, huge falsification, huge bonds, and a lot of that has to do with the repeal of the Glass–Steagall Act and the way in which the whole manipulation of financial investment then was just brought into play.

So I am just wondering. Maybe Dr. Posen might want to comment on that and give us some insight.

Mr. Posen. Thank you, Congressman.

If you ask a central banker like me what is wrong, I will say monetary policy was right, regulation was wrong. If you ask a private banker or a Treasury person, he or she will tell you monetary policy was wrong and regulation was right. So obviously you have to sort your way through the biases.

But essentially unbidden from that I would have started out with a variant of what you said as the root cause. It was not so much we deregulated excessively, it was that regulation was not allowed to keep up with financial developments for the last 15 to 20 years. And supervision was actively discouraged for much of that time.

Ned Gramlich, the late former Federal Reserve Governor, has documented this very clearly in how the Federal Reserve let us down in the mortgage market. There has been good reporting about the opposition to having any sort of regulation over derivatives.

There was the failure to decide to let SIVs, various off-balance-sheet vehicles be taken seriously as part of the mandate. I mean, essentially what happened was you had the Sandy Weills of the world coming to see Alan Greenspan in the mid–1990s and saying, look, there is an uneven playing field. It is what Krugman now calls the Shadow Banking System. Here (indicating one level) and we are here (indicating another level), and I want to compete. Give me an even playing field.

And the way that could have been dealt with was to bring it more into line, and including putting more regulations on the advantaged part of the field, the nonbanks.

Instead what happened was everything was done to use Federal Reserve and supervisory discretion to ease the regulations on the traditional banks. And so that ultimately was the core of the problem.

Monetary ease certainly helped. But if there had not been monetary ease you would still have had much of the same outcome. It is only if there had been extreme monetary tightening could you have prevented that.

So where do we go from here? Actually it is funny, given the differences in analysis. I actually very much agree with Mr. Altman in terms of what are the components of the prescription.

We have the Stimulus. I commend the Congress and the Administration for getting it through. It is not perfect, but it is good. That will put some check on how far down things go, and that buys us time.

We are going to do some kind of asset assessment on the banks, and we are going to have some form of getting the bad assets off the books. Again, we can disagree about the particular ways. My concerns are more about what the taxpayer gets in return, and what is the accountability. But in the end, if you do a bad job of it it is only money. But the important thing is getting that stuff off the banks.

Another piece of it, I am less concerned frankly about direct interventions in the housing market. Another piece of it though is we do have to do the kind of long-term down payments other Members on this committee were talking about to Chairman Volcker and that the President spoke about the other night, because that is what allows us to keep the interest rates anchored so we can fund the things we need to fund.

So in point of fact, the disagreements matter a great deal for what happens when you all sit down to restructure the system going forward, but there is a very wide range of economists and policymakers and business people from right to left who largely agree on the prescriptions, and there is a good reason for that.

Chair Maloney. Thank you.

Mr. Hinchey. Thank you.

Chair Maloney. Secretary Volcker talked about moving forward and how we would face this financial restructuring, and he mentioned it should not be done in a piecemeal way, but in an overcomprehensive way, and how possibly capping leverage, or restricting leverage, and having functional responsibilities of banks returning to their primary responsibility, whether it is commercial banking, insurance companies just doing insurance.

Would you comment, starting with Mr. Altman, on how you see the restructuring that we confront going forward?

Mr. Altman. Well Chairman Volcker I thought made a very, very important point, which was that we need a broad overhaul of all financial regulation. And I might say it seems to me that the Administration and the Congress are going to put one in place.

But, that we should start from a full-fledged blueprint rather than try to do it, as he said, piecemeal. Because this is regulatory reform of the most complex and most important order.

Chair Maloney. Um-hmm.

Mr. Altman. There are a series of proposals, or frameworks which have been put forward, most particularly the Group of 30 Framework with Chairman Volcker himself chaired and the report that he had with him today, which I am sure my fellow panelists also have read—it is a really good starting point—but Tim Geitner testified on this extensively a couple of times here before the Congress as President of the Federal Reserve Bank of New York, and his testimony really provides an important blueprint there.

And of course Secretary Paulson laid out a blueprint himself almost a year ago—it was March of 2008—under very different circumstances, but some parts of that, like merging some of the regulatory agencies will still stand the test of time.

This is going to be a very big job, I would think the number one job for the two Banking Committees, and it is probably going to be tough and long, because there are so many vested interests at stake, and it is very complicated. But if you stop and think about it, we have had the greatest regulatory failure in the modern era here, the single greatest.

Put aside any other regulatory example, this is the greatest failure we have ever seen. And it is really quite across the board. And it is the greatest cry, so to speak, for regulatory overhaul any of us will ever see.

So we need to do this right. I suspect it will take most of 2009 to do this, from a legislative point of view. It could even slip into 2010. But we really need to do it right. And it is a big, difficult job. We have nine separate financial regulators. That does not make sense.

We ended up having two banking systems—one what we think of conventionally as the banking system; one, as Dr. Posen referred to, as the Shadow Banking System, that ended up being just as big as the other one, but it was unregulated. It was highly leveraged. It financed itself primarily on a short-term basis. And it was the source of most of these problems, not all of them but a lot of them.

Investments banks, mortgage finance companies, and so forth. So we need to have, as Mr. Volcker and others have said, for institutions that are, you can call them systemically important, you can call them important participants in the money market, they need to be subject to the same regulatory framework from the point of view of prudential supervision, and they need to be subject to the same regulator.

That is probably the single starting point. But this is going to be very complicated and very, very important, because we cannot allow a collapse like this to occur again.

Chair Maloney. Thank you.

Dr. Posen, and then Dr. Mason, for your comments.

Mr. Posen. Thank you, Chairwoman Maloney.

I want to pick up exactly where Dr. Altman left off, Mr. Altman left off—Secretary Altman, whatever—Roger—— [Laughter.]

Mr. Posen. Very gracious. This being the biggest regulatory failure and it cutting across a wide range of points, and I may actually preempt a bit Professor Mason because I want to pick up on a couple of things he said in his opening remarks.

Which is, a lot of this had to do with too-big-to-fail, or too-systemic-to-fail, and fears about that.

And (b), a lot of this had to do with the central bank and the supervisors having too much discretion. I mean, that was sort of the underlying theme of many of the questions asked of Chairman Volcker before and being asked now, which is:

Okay, we have a lot of rules in place. Some of them were not enforced. We had a lot of inconsistency across regulatory agencies. We had a general sentiment over a certain number of years not to overregulate, or oversupervise, and whoever was in office adhered to that.

And so I think moving forward the Congress and the Administration have to think about a very fundamental change not just in the structure but in the nature of it.

We have to move even more, to my mind, to a rules-based system with very simple, very clear rules: that you do not get a lot of discretion to enforce in some black-box way. And we can go into the value and risk models and all these things that the banks were allowed to do for self-enforcement.

In addition, I think one of the things which was raised in the G–30 Report, which I also commend, is the idea that if you take too-big-to-fail seriously you have to take seriously the fact that you do not want to have banks that are necessarily that big.

I think in the end there is a sentence there, and Chairman Volcker's testimony today where he backs off that a little bit and says, well, but you will inevitably have a certain number of very large institutions, systemically important institutions and you just have to watch them extra carefully.

I am not entirely sure that we have to make that compromise. I think, no, there are not anti-monopoly reasons to break up large institutions, but if, God forbid, as I fear may happen, the U.S. Government ends up owning significant shares of a number of systematically important institutions, it is going to have to make a choice about the structure anyway. And it may be possible to break those up as part of the reselling them back to the private sector.

Chair Maloney. Thank you. Professor Mason.

Dr. Mason. Thank you. I am going to pick up on a little bit of both, what both of you said with respect especially to rules and to functionality.

Really I view the source of this crisis as originating back with the imposition of Basel I and attempting to regulate by a rule which we called a "regulatory capital ratio."

When that happened, in fact on the tail end of a recession, a lot of banks could not make that regulatory capital cutoff and they also could not find new capital so they found securitization as a very handy way to reduce assets instead to manage the regulatory rule.

So any time government lays down a rule, Wall Street immediately puts to work thousands if not millions of attorneys to figure out how to get around that rule and arbitrage that somehow. And I think that is a very important element that needs to be built into any new regulatory framework, just the admission that millions of minds are going to think about how to arbitrage this and they probably will figure it out. And so the new regulatory system has to be flexible and dynamic in order to keep pace with the Street.

In terms of functionality, I see functionality as beginning with what Chairman Volcker talked about, which is really going back to First Principles and really, really basic First Principles.

Imagine if we are setting this system up for the first time. We think of a financial system as having an array of institutions, some of which take a lot of risk and operate unregulated and do whatever they want, and others are very constrained in the public interest.

We need to decide who those institutions are and what they are going to be called. Once we set that up, then we have certain gravitational conditions you can call them, basically risk can travel from regulated to nonregulated firms but it probably should not be flowing the other direction; otherwise, you are setting up a regulatory arbitrage and the kind of problems that got us to the current crisis.

So identify what those risks are and how they are supposed to flow. Then, when you have a regulated commercial banking system that is funding itself in an unregulated market system, you know risk is probably flowing the wrong way and you stop it.

This also gives us a way to think about fungibility of risk. Risk can transform. In fact, in what I described earlier about securitization, we had risk being transformed from contracted credit risk claims to uncontracted reputational risk claims.

We need to think really hard about, again, how financial institutions are working to get around the rules so that we can always at least keep pace with them in the debate.

One thing I noticed through my years at OCC is that the Street has many more attorneys than the regulators do. They are always going to be out in front. That is fine. But we can still do a much better job of keeping pace. Looking back through the industry we can point to industry expressing concerns with all the weaknesses that are faced with us today to regulators who refuse to listen.

Thanks.

Chair Maloney. Thank you very much. I just would like to announce that Members may submit their statements and questions for the record.

I thank all the panelists, and the meeting is adjourned. Thank you.

[Whereupon, at 1:08 p.m., Thursday, February 26, 2009, the meeting was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF CAROLYN MALONEY

Good morning. I want to welcome former Chairman Volcker and our other witnesses and thank you all for your testimony today. Chairman Volcker, when it comes to understanding the economy and financial markets, you are in a league with only one player.

Over the past two days, we have heard rather sobering testimony from Fed Chairman Bernanke that, even under the best of circumstances, our economy remains perhaps a year away from making a full recovery. The problems plaguing the real economy and the financial system are intertwined, so it is critical that we act as swiftly as possible.

At the core of the ongoing liquidity crisis is the decline in home prices. Home prices continued their free-fall at the fastest pace on record in December. Since the beginning of this crisis, Congress has been working on keeping families in their homes. We are now working closely with the new Administration to reverse the deepening decline in home prices. Today, the House will consider H.R. 1106, the Helping Families Save Their Homes Act, which is designed to spur loan modifications and avoid bankruptcy for homeowners.

Strong indications are that this downturn could be the worst in the post-World War II period. The current recession, which began in December 2007, has caused massive job loss and a precipitous decline in economic growth. Congress recently passed the nearly $800 billion American Recovery and Reinvestment Act (ARRA), which provides fiscal stimulus in the form of aid to state governments, infrastructure spending, increased unemployment insurance and food stamps, and tax breaks to middle class workers and families. This package is designed to stem the real human costs and our economic losses by creating millions of jobs, helping families in need, and investing for the future.

The concern is that effects of our recovery package may be blunted if the financial crisis lasts too long. The Federal Reserve has taken extraordinary steps to maintain the operation of our financial and credit markets, but clearly, we need a comprehensive plan to return to well-functioning markets. In his address to Congress Tuesday night, the President pledged to work with Congress to adopt new "rules of the road"—a reformed financial regulatory structure to prevent future crises and hold financial executives accountable.

Our entire regulatory system is in serious need of renovation. It failed to properly identify risky mortgage-related assets. It did not recognize that these risks were being concentrated in highly-leveraged and important financial institutions. And it failed to anticipate the dangers posed to the financial system as a whole by these concentrations of risk. It also failed to provide mechanisms for dealing with the failure of important non-depository financial firms.

These shortcomings must be addressed. Regulators must obtain better information, better measures of systemic vulnerability, and the authority necessary to head off threats to financial stability. It is obviously too costly to leave the regulatory system as it is.

As winter turns to spring, my hope is that these efforts will break the downward spiral of our economy and bring about a thaw in credit markets, but even more may need to be done.

I look forward to our witnesses views on reviving our economy and restoring our financial markets.

PREPARED STATEMENT OF SENATOR SAM BROWNBACK

Thank you Chairwoman Maloney for arranging today's important hearing and thank you Chairman Volker and members of our second panel for testifying today.

Our economy is in the midst of a serious recession and many Americans are suffering from job losses, home losses, and uncertainty about their retirement savings, their jobs, and their children's future. Unfortunately, in addition, our financial system remains a problem.

I would like to begin by assuring every American that I am acutely aware of the pain and suffering that they feel. I also would like to assure them that, as always before, we will join together to confront our challenges head-on and emerge strong.

Given the severity of the economic downturn that we face, and efforts already under way to try to offset the downturn, it is absolutely clear to me that the very last thing we want to do is raise taxes. We know from experiences in the Great Depression and elsewhere that moves to stimulate an economy can easily be overwhelmed when the government also tries to raise taxes to shore up its budget. Unfortunately, in the midst of our current economic difficulties, there are those who wish to raise taxes using class-warfare rhetoric.

We cannot afford "tax cuts for the rich," according to the rhetoric. Yet, we know that, because of complexities in our tax code, there are many small business owners who declare business income as personal income, and many of those fall into the category of "the rich." Those small business owners often plow their incomes back into their businesses and, by most definitions, are hardly people you would think of as rich. By increasing taxes on those business owners under the guise of "taxing the rich," we are going to end up taxing small business owners who will respond by reducing their business activities, reducing their employment of workers, and reducing their investments necessary to keep their businesses running and growing.

We also cannot afford, under the rhetoric of eliminating "tax cuts for the rich," to increase taxes on income from capital, such as dividends. It might be comforting to some to think that increasing dividend taxes will somehow get even with rich fat-cat stockowners. But we know that higher dividend taxes will hurt many people not ordinarily thought of as rich, like a retired couple counting day-to-day on dividend income from stock investments that they made over a lifetime of work.

It is not the time to increase taxes, but the looming financial imbalances in our entitlement programs and significant spending aimed at "stimulus" and financial stability mean that we continue to pile up debt, which threatens long-run economic growth. Overconsumption, indebtedness, and speculation contributed to the current crisis, and yet the government is currently traveling down the same road with massive amounts of deficit-financed spending, speculating on success of an expansion of government and long-term spending under the guise ofstimulus. We need to cut the rate of growth of government spending and live within our governmental means.

In the face of a severe downturn in the economy, and a downturn that has accelerated in recent months, and in the face of significant declines in stock values and homeowner wealth, it is almost inconceivable that there are those who wish to raise taxes. What will increased taxes on small business owners do to job creation? What will increased taxes on dividends and other forms of capital income do to stock values and the portfolios of every American family? Now is clearly not the time to increase taxes.

In our financial system, the time has come to restructure the system and our regulations to prevent recurrence of a crisis like the one we are experiencing. One thing seems clear: we need to prevent speculative and highly leveraged excesses from threatening the stability of our entire national and global financial system. We are currently grappling with institutions that are deemed "too big to fail." They have become so big, and so complex, and so intertwined with more stable institutions that we fear that they cannot be allowed to fail or the entire system will collapse.

The large institutions engaged in highly leveraged, complex, and risky investments with the understanding that: on the upside, they win; on the downside, they will be backstopped by taxpayers because their institutions are too big to fail. That means private gains on the upside and public losses on the downside. And that is not a desirable or acceptable system.

I am interested in what Chairman Volker and other panelists have to say on how we can restructure the financial system to avoid the "heads we win, tails the taxpayers lose" situation that has developed.

I would also like to close by noting a recent letter sent by a medical doctor on the University of Kansas faculty to The Economist magazine regarding speculation in banking. Dr. Frederick Holmes of Kansas City, Kansas writes that:

> *. . . responsible people and responsible institutions have not hurled themselves, lemming-like, into the abyss of ruin. Despite the death knell sounded throughout the media, most people and most banks did not encumber themselves with mountains of unsecured debt. In the conservative heartland of America we have avoided the razzle-dazzle of "sophistication" and "computer-modelling" when managing our finances.*
>
> *I have entrusted a locally owned bank in Kansas City with my money for more than 40 years, and it has been a good steward of my modest wealth. Last year the chief executive posted a brief notice on the bank's website to reassure depositors. It read, "When the siren song of the subprime-mortgage market came along we took the long view and turned a deaf ear." I am going to leave my money with the folks at this bank for the next 40 years, for they seem to have the intelligence and common sense largely absent in the leadership of large banks.*

There are many people in the heartland who are genuinely and rightly upset that they are now being asked to support the highly leveraged speculative bets placed by the big institutions that are "too big to fail." I am interested in determining how we can prevent this from happening again.

PREPARED STATEMENT OF REPRESENTATIVE KEVIN BRADY

I would like to join in welcoming the witnesses appearing before us today. Current financial and economic conditions pose serious challenges to policy makers.

It is widely agreed that nothing else we do will matter much until the issue of how to dispose of toxic bank assets is resolved, but neither the Bush nor Obama administrations have devised a solution to this admittedly difficult problem. The recent Treasury proposal has not been well received because it did not clearly address this issue. The Economist magazine, for example, said that it looked "depressingly" like TARP I: "timid, incomplete, and short on detail." The lack of specifics has undermined confidence and contributed to financial market instability. A better approach is needed to help foster recovery.

The collapse of the credit boom and fall in related asset values has already wiped out many trillions of dollars of wealth held by both households and financial institutions, while plunging the economy into a deep recession. It also appears that the financial position of the federal government will deteriorate sharply over the next decade. The Congress has passed a partisan stimulus bill that relies heavily on deficit spending to boost the economy. However, as economist John Taylor noted in a recent paper presented at the annual American Economic Association meetings, "there is little empirical evidence that government spending is a way to end a recession or accelerate a recovery."

The 2009 budget situation was projected to deteriorate dramatically, but the stimulus legislation makes the situation even worse. Federal spending is expected to increase to at least $3.7 trillion, an increase of $685 billion or 23 percent in a single year. Federal spending as a percentage of GDP is set to increase from 20.9 percent to 25.7 percent, a post WWII high. The huge increase in federal spending, along with a fall off in revenue, will push the deficit to at least $1.4 trillion in 2009, a record level and a staggering 200 percent increase over its level of the previous year. The real budget outlook is actually considerably worse because the CBO calculations do not include a number of items that will further enlarge the deficits.

The enormous increases in deficit spending will push the publicly held debt from $5.8 trillion in fiscal 2008 to $7.4 trillion in 2009. The publicly held debt as a percent of GDP is expected to increase from 40.8 percent in 2008 to 51.8 percent in 2009, a large 11 percentage point increase in only one year. Moreover, the added spending of the stimulus bill will push this debt-to-GDP ratio to about 60 percent by 2011. One recent paper released by the Brookings Institution suggested that $1 trillion annual deficits could persist for each of the next ten years under what the authors consider to be optimistic economic assumptions.

The prospect of borrowing over a trillion dollars for questionable programs thrown together with little procedural deliberation has rightly given the American people pause. However, bailouts for the financial sector, auto industry, and others could add trillions to the projected debt in coming years. According to a recent Bloomberg report, ". . . the stimulus package the U.S. Congress is completing would raise the government's commitment to solving the financial crisis to $9.7 trillion, enough to pay off more than 90 percent of the nation's home mortgages. . . ." Nearly $8 trillion of this total reflects lending and guarantees provided by the Federal Reserve and Federal Deposit Insurance Corporation (FDIC). Clearly, trillions of dollars of exposure to distressed borrowers does not enhance the financial position of the U.S. government.

In a recent influential paper, economists Carmen Reinhart and Kenneth Rogoff examine the history of financial crises. Among their findings is that the debt of the central government jumps an average of 86 percent in the years following a financial crisis. This would translate into a level of $11 trillion for U.S. publicly held debt in a few years. Unfortunately, current trends suggest we are well on our way to this kind of outcome.

The U.S. Treasury is expected to raise as much as $2 trillion in 2009 to finance the extraordinary financial demands placed by recession, growing bailouts, and stimulus measures on the government. Similar steps by other major countries will intensify the upward pressures on interest rates. The recent increases in long-term mortgage rates are especially troubling given the condition of the housing sector.

Furthermore, the looming retirement of the baby boom generation will cause entitlement spending to accelerate faster and faster in coming decades. It is widely recognized that without policy changes, long-term imbalances in entitlement programs will cause publicly held federal debt to balloon out of control. In 2007, the Congressional Budget Office (CBO) projected under an extended baseline scenario that publicly held federal debt will eventually climb to 239 percent of GDP without policy changes.

One risk is that the high levels of deficit spending and debt accumulation may signal to global financial markets that the United States is unwilling to resolve its long-term budgetary problems. As a result, U.S. interest rates could increase significantly. As the recent paper released by Brookings notes, ". . . Recent trends in credit default swap markets show a clearly discernable uptick in the perceived likelihood of default on 5-year U.S. senior Treasury debt, a notion that was virtually unthinkable in the past . . . although fiscal policy problems are usually described as medium- and long-term issues—the future may be upon us much sooner than previously expected."

The bottom line is that the fiscal position of the federal government is deteriorating significantly and the outlook is fairly grim. The looming possibility of large bailouts could add trillions of dollars to the national debt. The truth is that this country simply cannot afford to make further spending commitments and must consider entitlement reforms and other measures to restrain the growth of runaway deficit spending. American families cannot afford policies that ignore surging federal spending, lay the groundwork for higher taxes and inflation, and undermine the prospects for future economic and employment growth.

PREPARED STATEMENT OF PAUL A. VOLCKER

Madame Chairwoman and Members of the Joint Economic Committee:

It is no secret that we are living in a difficult time for the economy, with unprecedented complexities, complications and risks for financial markets and financial institutions. You have entitled this hearing "Restoring the Economy: Strategies for Short-term and Long-term change". I appreciate the invitation to address those issues, but I am sure you understand that any brief statement may elicit as many questions as answers. In the circumstances, I will proceed by making a few points that I consider highly relevant in the effort to achieve recovery, greater stability, and protection against a future financial crisis. We must not again leave the markets so vulnerable that a breakdown will again threaten the national and world economies.

1. My first point is to emphasize an essential longer-term reality.

The present crisis grew out a serious and unsustainable imbalance in the United States and world economies. Specifically, over recent years, until the outset of the recession, Americans spent more than our country produced or was capable of producing at full employment. That spending, reflected in exceptionally high levels of consumption generally and in housing in particular, was made possible by a high level of imports, a collapse in personal savings, and large trade and current account deficits. The consequence was the nation became dependent on borrowing abroad hundreds of billions of dollars a year.

For a while it was all quite comfortable. Imports from China and elsewhere satisfied our strong consumption proclivities without inflationary pressures. China, Japan and other countries were eager to export and willing to acquire and hold trillions of U.S. dollars, keeping our currency strong and helping to keep our interest rates low.

The trouble was it could not last. The process came to be dependent upon an enormous build-up of domestic as well as international debt, facilitated by the low interest rates and sense of "easy money". The bulk of that debt came to be mortgage-related. It was supported by the strong increase in housing prices, giving the illusion of wealth creation. When housing prices leveled off and then declined, the weakest mortgages—so-called subprime—came under pressure, and the highly engineered over-extended financial structure began to unravel. As the financial crisis broadened, the recession was triggered.

I repeat that story because the first and most fundamental lesson of the crisis is that future policy should be alert to, and take appropriate measures to deal with, persistent and ultimately destabilizing economic imbalances. I realize that is a large and continuing challenge of international as well as domestic proportions, but it is the essence of prudent economic management.

2. Secondly, I turn to the problem in financial markets.

The rising debt, particularly mortgage credit, was facilitated and extended by the modern alchemy of financial engineering. Mathematic techniques that have developed in an effort to diffuse and limit risk turned out in practice to magnify and obscure risks, partly because, in all their complexity and opacity, transparency was lost. Risk management failed. At the same time, highly aggressive compensation practices encouraged risk taking in the face of misunderstood and sometimes almost incomprehensible debt instruments.

As we look ahead, the obvious lesson is the need for more disciplined financial management generally and better risk management in particular. Plainly, review and reform of compensation practices are particularly difficult matters that defy rigid specification.

3. As the financial crisis evolved, weaknesses in accounting, credit rating agencies and other market practices were exposed.

"Fair value" accounting rules were inconsistently applied and have contributed to downward spiraling valuations in illiquid markets. Credit rating agencies failed to analyze collective debt obligations with sufficient vigor. Clearance, settlement and collateral arrangements for obscure derivative contracts created uncertainty and need clarification.

These are all highly technical issues, not readily dealt with by legislation. They do need to be resolved as part of a comprehensive reform process.

4. More directly of governmental concern are the lapses in financial regulation and supervision that permitted institutional weaknesses to fester, failed to identify exceptional risks and deal adequately with conflicts of interest, and did not expose large personal scandals after warnings.

This area will require, and I'm sure will receive, close attention by the Administration and the Congress in the period ahead. I will be surprised if you do not conclude that substantial changes will need to be made in the administrative structures for oversight of the financial system.

Taken together, the need for change is both obvious and wide ranging. In approaching the challenge, I do urge that all these matters be considered in the context of a considered judgment about the appropriate role and functioning of the financial system in the years ahead.

At the most general level, I am certain we all would like to see a "diverse, competitive, predominantly privately owned and managed institutions and markets, able to efficiently and flexibly meet the needs of global, national and local businesses, governments, and individuals".

Those words are taken directly from a recent report of the Group of 30 setting out a Framework for Financial Stability. It points up the challenge of making those broad generalities a strong and lasting operational reality. I chaired that effort and naturally recommend it to you.

The Report makes some eighteen broad recommendations, touching upon most of the points I enumerated earlier. One area it does not cover are specific proposals for restructuring the agencies responsible for regulation and supervision. I believe judgment and legislation in that area should logically follow and not proceed judgment about the overall design of the financial system.

The G-30 Report recognizes what I believe is common ground among most analysts. Specifically, all banking organizations should come with the framework of an official safety net, with the natural corollary of regulation and supervision. It is also recognized that a few of the banks (and possibly some other financial organizations) will be so large, and their operations so intertwined in complex relationships with other institutions, as to entail "systemic risk". In other words, the functioning of the financial system as a whole could be jeopardized in the event of a sudden and disorderly failure. Consequently, those institutions should be subjected to particularly high international standards directed toward maintaining their safety and soundness.

Taken together these banking organizations should be predominantly "relationship-oriented", providing essential financial services to individuals, businesses of all sizes, and governments. To help assure their stability and continuity and limit potential conflicts of interest, strong restrictions on risk-prone capital market activities—e.g., hedge funds, equity funds, and proprietary trading—would be enforced.

At the same time, trading and transaction-oriented financial institutions operating primarily in capital markets could be less intensively regulated, although stronger registration and reporting requirements would be appropriate. In instances where the institutions are so large or otherwise so complex as to be "systemically" relevant, capital, leveraging and liquidity requirements would be imposed.

Implicit in this approach is the need for strong cooperation and coordination among national authorities and regulators. Some approaches—accounting standards, capital and liquidity requirements, and registration and reporting procedures—should be internationally agreed and consistent in application to minimize regulatory arbitrage and any tendency by particular countries or financial centers to seek competitive advantage by tolerating laxity in oversight.

All this will take time if the necessary consensus is to be achieved and a comprehensive rather than a piece-meal approach is taken. I also recognize that a coherent vision of the future should help guide the emergency responses to the present crisis and, even more important, the steps taken as the truly extraordinary measures now in place are relaxed and ended.

Let that debate proceed. I will, of course, welcome the opportunity to participate in your deliberations.

PREPARED STATEMENT OF ROGER C. ALTMAN

Madam Chair and Members of the Committee, thank you for inviting me to testify before you this morning.

This is a historic and deeply challenging moment in the annals of finance and public policy. It is historic because the Western financial system is experiencing shocks which virtually no one foresaw, no one imagined, and few truly understand. It is deeply challenging because, while the finance and monetary authorities have launched very aggressive interventions over the past year, it is not yet clear whether these will successfully stabilize the financial system. My view is that these efforts have been well-conceived and will prevail. It may not be evident that they have done so, however, until 2010.

True Origins of the Crisis

We all have read and heard endless analyses of how this collapse occurred. But one widespread misperception still persists.

Conventional wisdom attributes the current crisis to the twin collapse of housing prices and the subprime mortgage market in the U.S. This is not correct. The underlying cause was an invariably lethal combination of extremely low interest rates and extremely high levels of liquidity.

Low interest rates reflected the Federal Reserve's overly accommodative monetary policy after September 11, 2001 and the recession of 2001 and 2002. The federal funds rate was held to 1% for nearly three years.

The extreme liquidity reflected what Chairman Ben Bernanke has called the "global savings glut." Namely, enormous financial surpluses realized by several developing countries, most notably China, Singapore, and the Persian Gulf oil states.

Facing low yields, this mountain of liquidity naturally sought higher returns and this led it to weaker credits. Huge amounts of capital thus flowed into the subprime mortgage sector—the 2005 and 2006 volumes were six times the long-term historical average—and towards weak borrowers of all types in the U.S., Europe, and elsewhere around the globe. As with all financial bubbles, historical default rates on these poor credits and other key lessons of history were ignored.

The flood of mortgage money pushed home prices up at unprecedented rates. The 30-year average annual appreciation rate had been 1.4 percent, but soared to 7.6 percent by the middle of the decade and ultimately reached 11 percent at the peak.

The rest is history. But, my point is,that low interest rates and high liquidity caused this bubble, not home prices and subprime mortgages.

A Subpar Economic Recovery

This is the first balance sheet-driven recession in over sixty years and, unfortunately, that factor mandates a sub-normal recovery.

In the modern era, recessions have typically reflected a sequence of overheating, inflationary pressures, monetary tightening, a slowdown in the credit-sensitive industries and then a broader slowdown.

However, the current downturn reflects plummeting asset values, which have injured household balance sheets, financial sector balance sheets, and ultimately will harm even the federal balance sheet. The net worth of consumers has fallen so dramatically that they cannot spend; the capital of banks and like institutions has fallen so sharply that they cannot lend; and the federal balance sheet has now been stretched to the point that the government will have no choice but to eventually undertake contractionary actions to repair it.

The reason the recovery will be delayed and lengthy—U shaped—is that these balance sheets cannot recover quickly. First, the consumer balance sheet. Households have lost nearly $15 trillion since mid-2007, or a fifth of their net worth. They have retrenched by cutting discretionary spending, which is why personal consumption expenditures have been dropping so fast. In turn, the savings rate has risen and now stands at approximately three percent. In the long run, a higher savings rate is desirable. But, right now, it is accelerating the downward spiral of job losses and falling incomes that is driving people to save in the first place.

An important psychological element also applies. In recent years, household incomes were stagnant, but spending rose anyway in proportion to the so-called positive wealth effect. Consumers knew that their home and financial asset values were higher and felt flush. Now, this perception has reversed sharply. It will take a long time for consumer balance sheets and consumer confidence to be restored.

A second factor mitigating against a normal recovery is the damaged balance sheets of our banking sector. Since the peak, losses among U.S. financial institutions and investors have reached nearly $1 trillion. But, there could be another $1 trillion in losses to come. This is why financial institutions are not lending. Adjusted for such losses, they have little or no true capital.

Eventually, the federal balance sheet will also become a restraining factor. Weakness in revenues, the stimulus bill and continued financial rescue spending will likely move the fiscal 2009 deficit over $1.5 trillion, or more than 10% of GDP. In addition, the Federal Reserve is pursuing a zero interest rate policy, as it should. But, such growing deficits and extreme monetary ease can only be maintained for so long without provoking anxiety in world capital markets, foreign exchange markets, and among the American public. As a result, the U.S. government will likely shift to deficit reduction strategies and monetary tightening by 2011, which will then have a contractionary effect on the economy.

The Continuing Credit Crisis

The credit freeze outside the banking system has begun to thaw slightly. But, the crisis within the banking system may be at its low point.

Beyond the depository and lending system, the public markets seem to have passed their lows: the TED spread has fallen 350 basis points since its October peak, commercial paper issuances have improved modestly, and both high grade corporate bond spreads and high grade corporate bond issuances are slowly recovering. But, this represents only a small thaw, as the securitization and high yield markets are still frozen.

The banking system continues to deteriorate. A rare, severe downward spiral is currently in motion; as the value of financial assets fall, institutions must further mark down their held assets. These losses reduce their underlying capital and weaken their balance sheets. The so called "hole"—the deficiency of tangible equity compared to the true market value of those assets—only grows. This explains why the market equities of Citigroup and Bank of America have shrunk to $10 billion and $19 billion, respectively. For example, with residential real estate, commercial real estate, and business values themselves continuing to fall, there is little tangible equity in Citigroup. As long as these values continue falling, its balance sheet will continue to weaken.

As a result, the amounts of capital needed to properly shore up the banking system are still growing. This system may well remain incapacitated through the end of 2009, even if public credit markets continue to experience gradual improvement.

The Federal Policy Response to Date

The actions of the Treasury Department and the Federal Reserve over the past 18 months have been commendable. They have not been perfect, of course. Given a second chance, they might make different decisions on Lehman Brothers, AIG, and the original presentation of the TARP. But these two agencies, together with the FDIC, have provided strong leadership.

First, they have injected or guaranteed a total of $9 trillion in credit market support. Second, they have responded with creativity, from the Fed's guarantee for money market funds and commercial paper, to the rescues of Fannie Mae and Freddie Mac, to the nearly 400 separate institutions that have received TARP funds to date, and to the FDIC's guarantees of large swaths of Citigroup and Bank of America assets.

It is worth noting that the RTC was a very unpopular institution during the savings and loan crisis of the late 1980s and early 1990s. But, in retrospect, the government established it swiftly and managed it expeditiously during those years. Now, the U.S. approach to that crisis is considered successful. This time, the challenge is greater, and the recovery will be slower. But, in my view, history will render the same verdict.

The New Obama Initiatives

Although the new Administration has held office for only 38 days, it has already launched four new initiatives to attack this economic and financial crisis.

The first was the $787 billion stimulus package. It wasn't perfect and could not have been. But few argue with the necessity for big fiscal stimulus under current conditions. Yes, with the economy likely declining for the first three quarters of 2009, and possibly all four quarters, it will be hard to discern an impact this year. But, most economists forecast that GDP will decline materially less this year than had the stimulus package not been enacted. We don't yet know, of course, whether this $787 billion will turn out to be a sufficient amount. If it isn't, a second round of stimulus may be necessary, perhaps in mid-2010.

The second initiative is the Capital Assistance Program, the new term for capital infusions into financial institutions from the TARP. The Administration has made a series of improvements relative to the Bush approach. For one, banks with assets exceeding $100 billion will be subjected to a financial "stress test" to determine their financial condition in a downside scenario. Presumably, this will have the effect of dividing them into three categories: those healthy enough to forego federal capital; those too weak to survive even with federal assistance; and those who need assistance but can be stabilized as a result. The Obama Administration will also designate clear lending requirements in exchange for federal capital, as well as place limits on dividends, buybacks, acquisitions of other wealthy institutions, and executive compensation. Finally, the new program will purchase convertible preferred shares, not straight preferred shares. This allows it to turn its investment into pure equity for the benefit of the assisted institution.

Thirdly, the new Administration has decided to pursue a Public/Private Investment Fund to incentivize private capital to acquire toxic assets. This is both the right financial approach and a courageous idea, because it will not be popular. We do not yet know the details, but it likely involves providing federal loans to hedge funds, private equity funds, and similar investors. These loans will likely come from the Federal Reserve, thus not requiring legislative approval. They will likely be provided on a non-recourse basis to investors at an initial amount of $500 billion, with the potential to expand to $1 trillion as needed. It will likely take three to four months for this complex partnership to become operational. For example, the TALF facility, which was announced in November is just now commencing operations.

The public/private approach addresses two key needs. First, it removes distressed assets from the balance sheets of weakened lenders, and second, it allows the private market to price those assets. But structuring this facility correctly will be a challenge. Taxpayers must share strongly in the profits realized by investors. The financing provided must be large enough to allow for active bidding on the toxic assets but not so large as to encourage overpricing them. And private investors will likely require floor protection from the FDIC and Treasury on any assets purchased. Furthermore, it is also unclear whether subsidized bids on toxic assets will be sufficient to induce a healthy volume of selling on the part of lenders, or whether those sale prices would trigger even larger losses, requiring additional capital infusions from the Treasury.

This approach is preferable to nationalization, which has been so widely discussed in recent days.

It is important to define nationalization, before a true discussion of its pros and cons can properly be had. The right definition, it seems to me, is 100% federal ownership of a financial institution.

It is also important, given the enormous uncertainties of the moment, to avoid categorical statements. At this moment, the U.S. cannot categorically rule out nationalizations. There are possible circumstances which are so cataclysmic as to leave no other alternative.

But, that is the only circumstance in which we should resort to this step. Here's why:

- Our government is not equipped to manage large financial institutions. For example, post-nationalization, most envision transferring an institution's toxic assets to a new formed federal institution: an aggregator bank, or "bad" bank. But, twenty years ago, it took years for the RTC to become fully operational. It would take a similarly long time here.
- Any nationalized institution would be further weakened by virtue of that step. Retaining business customers and key talent would be difficult during a period of federal ownership. Those institutions which remains in private hands would benefit, at the expense of the federalized ones.
- The temptation to direct nationalized institutions towards public policy goals, however commendable, would be severe, e.g., "green lending." Such a focus would be inconsistent with the goal of swiftly returning a nationalized entity to profitability and financial soundness.
- It would take longer to re-privatize a nationalized institution than many estimates that I have seen. Once taken over, our capital markets will see the institutions as weakened. Such markets will be slow to embrace efforts to re-sell them to investors, except at fire sale prices.
- The oft-cited Swedish example of bank nationalization is not particularly comparable. By American standards, Sweden is a small country, and these were two small institutions.

- It also is not necessary to nationalize in order to change senior management or the Board of any federally assisted institution. The Treasury has that power today. If it has furnished substantial TARP funds, it can simply request that the management or Board, or both, be replaced, as a condition of continuing the investment. Any institution would comply.

The final initiative is that towards the mortgage and foreclosure crisis. This was long overdue.

The new plan is designed to make three impacts: (1) more flexibility for Fannie Mae and Freddie Mac to acquire and to restructure mortgages; (2) greater overall capacity to restructure existing mortgage loans and ease debt service for distressed homeowners; and (3) the ability to write down principal amounts of mortgages in the context of bankruptcy.

The Fannie and Freddie changes would permit refinancings where the mortgage value exceeds 80% of the underlying home value, provided that it doesn't exceed 105% of the value. This could allow several million homeowners to refinance at lower rates, lower their mortgage debt service and stay in their homes. We should see a considerable increase in related refinancings.

Further, the Obama proposal provides cash incentives for mortgage servicers to restructure mortgages. The goal is to lower the debt service to income ratio, in as many cases as possible, to the low 30% range, including through principal reductions. It is not clear how many servicers will participate in this plan but it is the right step because it addresses borrowers who are at risk but may not yet be delinquent.

The mortgage and foreclosure crisis is difficult to address because millions of individual loan modification transactions are required. Unfortunately, it is just as time consuming to restructure a small mortgage, as it is to modify a huge one. Therefore, we face a big "retail" problem. Namely, how to actually interact with such a large number of homeowners and their mortgages. There is no magic solution here, and even the impacts of this new initiative may take some time to be felt. But, it was necessary.

Prepared Statement of Adam S. Posen[1]

Chairwoman Maloney, Members of the Committee, thank you very much for inviting me to testify today at this critical juncture in American economic policymaking. I am especially honored to be following the testimony of Paul Volcker, one of the greatest public servants this country has had in the economic sphere, to whose wisdom we all would do well to listen.

Today, we face extreme financial fragility and as a result serious risks to our economy's prospects for a sustainable recovery from its current troubles. Congress must grapple with difficult choices about America's banks, and make those choices soon. Making the right choices now will require money upfront, large amounts of taxpayer money, and thus it is necessary as well as right for Congress to lead on this issue. But making the right policy choices now will restore US economic growth much sooner, at much lower cost, on a more sound basis, than trying to kick the trouble down the road or waiting for events to force the issue. Members of this committee are well-familiar with such warnings, usually with respect to far off economic problems. This time and this problem, however, are costing our citizens jobs and homes and hard-earned savings right here and now. And the correct policy response right now will make all the difference.

Luckily, although the scale of the banking problem that we now face is unfamiliar to us, the kind of banking problem we face today is familiar, and in fact well-understood. We have seen this before in the US in the mid-198os Savings and Loan crisis, in Japan's post-bubble Great Recession of the 1990s, in the Nordic countries from 1992–1995, and many times in many other countries. It is reasonable to ask why these kinds of crises keep happening, and how to prevent them in future—I would be happy to discuss that, but that is of lesser importance to our current circumstances. It is also reasonable to ask why economists who did not foresee the current crisis can be trusted to give advice with great assurance now that the crisis has hit. I would say this is analogous to the doctor who does not foresee that his

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patient's common cold will turn into pneumonia (or at least saw it as quite unlikely), but knows how to treat the pneumonia once it occurs.

So today I would like to advise you on how to cure our financial pneumonia, rather than letting it runs its course, before it causes permanent damage or leads to hospitalization of our economy. And the prescriptions I will give are based on many prior cases, particularly what worked to bring financial recovery in the US in 1989 and in Japan in 2001, which are the ones most similar to our current condition.[2] In brief, I would urge the Congress to have the US government:

- Recognize that the money is gone from the banking system, and banks already are in a dangerous public-private hybrid state;
- Immediately evaluate the solvency and future viability of individual banks;
- Rapidly sort the banks into those that can survive with limited additional capital, and those that should be closed, merged, or nationalized;
- Use government ownership and control of some banks to prepare for rapid resale to the private sector, while limiting any distortions from such temporary ownership;
- Buy illiquid assets on the RTC model, and avoid getting hung up on finding the 'right price' for distressed assets or trying to get private investment up front, which will only delay matters and waste money;
- When reselling and merging failed banks, do so with some limit on bank sizes;
- And do all of this before the stimulus package's benefits run out in mid-2010.

This set of decisive actions is feasible and can be rapidly implemented, and follows a proven path to the resolution of banking crises. Implementing this program should spare us the fate of squandering additional national wealth and of postponing recovery for years that resulted from policy half-measures in Japan in the 19905 and in the United States in the 1980s. Similar policy frameworks were adopted and resolved those crises in the end, but only after delay cost dearly.

Recognize that the money is gone from the banking system, and banks already are in a dangerous public-private hybrid state. There are statements in the press of late by bank managers and unnamed administration sources that some major banks currently under suspicion of insolvency actually have sufficient capital, or, slightly less dubiously, would have sufficient capital if only they were not forced to mark their assets to current low market values. These statements should treated with extreme skepticism if not disdain. There are certainly some American banks that are either solvent, or sufficiently close to solvency that they can be returned to viability at little cost, despite the severe recession and market declines. But I agree with the vast majority of independent analysts and the obvious market verdict that sadly for many of our largest banking institutions solvency is but a far-off aspiration at present.

And it is the present condition that matters. In the mid-1980s in the US and most of the 1990s in Japan, bank supervisors engaged in regulatory forebearance, meaning they held off intervening in or closing banks with insufficient capital in hopes time would restore asset values and heal the wounds. One can easily imagine the incentives for the bank supervisors, well-documented in historical cases and the economic data, not to have a prominent bank fail on their watch. The problem, also evident in these historical cases and in the economic data, is that top management and shareholders of banks know that supervisors have this interest, and respond accordingly. The managers and shareholders do everything they can to avoid outright failing, which fits their own personal incentives.

That self-preservation, not profit-maximization, strategy by the banks usually entails calling in or selling off good loans, so as to get cash for what is liquid, while rolling over loans to bad risks or holding on to impaired assets, so as to avoid taking obvious losses, and gambling that they will return to value. The result of this dynamic is to create the credit crunch of the sort we are seeing today, and to only add to the eventual losses of the banks when they get recognized.[3] The economy as a whole, and non-financial small businesses in particular, suffer in order to spare the positions of current bank shareholders and top management (and on the firing line bank supervisors).

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[2] I draw on a wide range of research by myself and others. A good overview is given in *Japan's Financial Crisis and Its Parallels with US Experience*, eds. Ryoichi Mikitani and Adam Posen, PIIE, 2001.

[3] Arguably, repeated forebearance of this kind when major American banks previously made poor decisions about emerging market lending and regional real estate booms, also contributed to getting us in to the terrible situation of today, by encouraging the largest banks to believe that they would always be bailed out without having to take the worst losses.

The guarantees that the US government has already extended to the banks in the last year, and the insufficient (though large) capital injections without government control or adequate conditionality also already given under TARP, closely mimic those given by the Japanese government in the mid-1990s to keep their major banks open without having to recognize specific failures and losses. The result then, and the emerging result now, is that the banks' top management simply burns through that cash, socializing the losses for the taxpayer, grabbing any rare gains for management payouts or shareholder dividends, and ending up still undercapitalized. Pretending that distressed assets are worth more than they actually are today for regulatory purposes persuades no one besides the regulators, and just gives the banks more taxpayer money to spend down, and more time to impose a credit crunch.

These kind of half-measures to keep banks open rather than disciplined are precisely what the Japanese Ministry of Finance engaged in from their bubble's burst in 1992 through to 1998, and over that period the cost to the Japanese economy from bad lending quadrupled from 5% to over 20% of Japanese GDP. In addition, this 'convoy' system, as the Japanese officials called it, punished any better capitalized and managed banks that remained by making it difficult for them to distinguish themselves in the market; falsely pumping up the apparent viability of bad banks will do that. That in turn eroded the incentive of the better and more viable banks to engage in good lending behavior versus self-preservation and angling for government protection.

I believe, regrettably, that is what is happening now in the US under the current half-measures. This is why further government intervention in the banking system, based on recognizing real losses and insolvencies is to be welcomed, not feared. So long as American banks have partial government guarantees and public funds to play with, but retain current shareholders and top management, they have perverse incentives and losses will mount. Think of Fannie Mae and Freddie Mac gambling with taxpayer dollars when having government guarantees but private claims on the profits and thus incentives for management and shareholder self-preservation. Hybrids are a good technology for autos—public-private hybrids are a terrible form for financial institutions. Thus, bending over backwards to keep all of the banking system in private hands without changing their management, while extending further government guarantees and investments is a recipe for disaster on the public's accounts.

Immediately evaluate the solvency and future viability of individual banks. The first step to ending these perverse incentives, and getting us away from the destructive undercapitalized private-public hybrid banking we now suffer under, is to get the books in order without hesitation about declaring banks insolvent based on current valuations. It was that kind of aggressive, intrusive, and published honest evaluation by Japanese officials of their banks in 2002 that was the first policy step in finally ending their banking crisis. Treasury Secretary Timothy Geithner has acknowledged the need for evaluations, and will shortly be implementing 'stress tests' on the 20 largest US banks. Unfortunately, it remains to be seen whether the supervisors and regulators sent in to make these evaluations will be sufficiently merciless in discounting the value of current assets. The administration has given conflicting signals on this point so far. Much of the opening rhetoric in the Secretary's statements on the matter is tough, which I applaud.

The statement that the stress tests will be implemented in a 'forward-looking' manner, however, potentially opens the door to backsliding. We are in the midst of a very severe recession, and a huge asset price decline, when most things that could have gone wrong have gone wrong. So it seems reasonable that the current situation is about the most stress that bank balance sheets could be expected to come under; and why bother considering worse situations, since all too many banks will fail the tests under the present stresses. In the US in the 1980s with the savings and loans, and in Japan in the 199os with all their banks, forward-looking (by other names) assessments ended up being forms of forebearance. When the assessments took into account future periods when conditions would be calmer and asset values would be higher than they were during the crises, they gave the banks an unjustified reprieve.

Granting such a self-defeating lifeline would also seem to be consistent with the repeated administration statements that they wish to keep the examined banks not only open and lending, but under continued private—and thus current—shareholder and management control. If this is the case, and I hope I am worrying unduly, it would be a grievous mistake. The fact that bank shares for many suspect banks have stopped dropping with the announcement of these programs, however, is another signal that many believe the stress tests will be beneficial to current bank shareholders. This stabilization if not bump in bank share prices cannot be based on a belief that the suspect banks will be revealed by the stress tests to be in truly better shape than the market believed them to be up until now, for then the private money sitting on the sidelines would be moving to acquire the (in that case) undervalued banks.

Another red herring, that I also fear indicates reluctance to do what is needed, are the occasional statements that the process will take several weeks or more, and will be difficult to implement given staffing constraints and complexity of the balance sheets. There is no shortage of unemployed financial analysts looking for consulting work, and there is no need to be all that caught up in getting precisely the 'right' price on various distressed assets (as I will explain). The implementation difficulties of such evaluations are surmountable, as they were in other countries such as Japan that had a new unproven Financial Services Agency in place when it got tough in 2002, and here at home when the first Bush administration took on the S&L crisis in 1989-1991. Furthermore, what have the bank supervisors of the FDIC, the Federal Reserve Bank of New York, et al, been doing for the last several years if not getting some sense of these banks' balance sheets? The Treasury cannot make public claims that the banks' balance sheets will be revealed to be better than expected, based on supervisory information, at the same time that it claims that making the evaluations of the balance sheets will be daunting.

So strict immediate evaluations of bank balance sheets are agreed upon in at least form. Regrettably, there is some risk that the forward-looking stress tests may indeed be yet another transfer of taxpayer dollars to current bank shareholders. The people's representatives in Congress should not stand for this. If it turns out that Congressional insistence on tough love for the banks merely stiffens the spine of the Treasury, FDIC, and Federal Reserve to do what they intended to do anyway, so much the better. Their apparent reluctance to pull the trigger on tough evaluations may be based on fears in the administration that such forced write-offs would require the unpopular steps of another injection of public funds and/or round of closures, either way involving some government ownership of those banks. Those fears can be forestalled through your committee clearly stating that this kind of tough evaluation is in the public interest, and the benefits outweigh the costs. You and your colleagues can and should make the stress tests work.

Rapidly sort the banks into those that can survive with limited additional capital, and those that should be closed, merged, or temporarily nationalized. Banks think with their capital. As discussed, when their capital is too low, the incentives for their top management and shareholders are perverted, and contrary to the public interest. Simply giving capital to all the banks that are judged to need some, however, is a mistake. It spends taxpayer money we do not need to spend, and it rewards bad behavior by treating all banks equally, no matter how much capital they squandered. It is better to triage the banks quickly into categories by their viability on the basis of capitalization.[4] This is what the Swedish government did rapidly with great success in 1992, when their banking crisis hit, and is what the Japanese government got around to finally doing in 2002, when their banking resolution became serious.

The capitalization criteria should not be simply whether the net position after strict balance sheet evaluation is above or below zero, i.e., solvency. As we learnt during the Savings and Loan crisis, and as therefore reflected in FDICIA, which allows supervisors to take over banks which have capital ratios of 2%, by the time you get to zero it is too late (of course, right now, the problem is that capital ratios will already be well below zero for many of the largest banks). So the three categories should be:

1. Banks with clearly positive capital that only need a topping-up to return to health and healthy behaviors;
2. Banks with low or slightly negative capital where removal of limited bad assets could restore viability; and,
3. Banks with clearly negative capital and large, difficult to unwind, portfolios of bad assets.

The first category should receive their capital topping up from public fund injections through preferred shares or other loans of liquid non-voting capital. This format, combined with a clean-bill of health from credible inspections, should lead to rapid repayment of these banks' public funds. Yes, this is what was tried in the early days of the crisis and TARP; that did not work because it was wishful thinking at best to do so for all the major banks indiscriminately before credible balance

[4] We are already sorting banks on the basis of systemic risk by virtue of stress testing the largest, and thus probably most systemically important, banks first. No one worries about closing small banks, usually.

sheet evaluations were completed. But for those banks within striking distance of solidly positive capital ratios, this is the right way to go.

The second category of banks likely includes many of the mid-to large-size, but not the largest size, banks in our system. These are banks that cannot get back to clearly positive capitalization, once their bad assets are fairly written off, but whose balance sheets can be rapidly cleaned up by bad asset sales and whose capital needs are not overwhelming. Banks in this category are usually sold off, in part or whole, to other banks, or are merged with stronger banks combined with some injection of public capital. As part of this process, current top management is usually replaced (perhaps 'naturally' in a merger process), and current shareholders' equity is diluted (though discounted purchases of bank components, public minority ownership of some common equity, or both).

It is the third category that grabs the political attention, and that unfortunately is likely to include some of our most systemically important banks. Clearly insolvent banks with no rapid way to sell off their assets at a discount would be unwound in an orderly fashion under FDICIA, but in essence liquidated over time if they were small and did not present a systemic risk. That has already happened during this cycle to a few American institutions, such as Indymac, and even in Japan's lost decade, some minor institutions (like Hokkaido Tokushokku bank, Japan's number 19 or 20 by size in 1998 when it was allowed to fail) were wrapped up in this fashion, despite the general reluctance to close banks. Obviously, the issue is what to do about systemically important large institutions with difficult to unwind balance sheets. And this is the category for which temporary nationalization of the insolvent banks is the right answer.

In short, nationalization is only relevant for a part of the banking system under crisis, even for only a part of the technically insolvent banks, but it is necessary for the most systemically important banks that are insolvent. These banks must be kept in operation and have their positions and bad assets unwound in deliberate fashion. They also must have top management replaced and current shareholders wiped out. This is because the amount of capital required to restore them back to functionality is so large, and the process of restructuring their balance sheet so complex, with both having the potential to influence markets for other banks' equity and asset prices, that only the government can do it. There will likely be private buyers a plenty for such a bank when the recapitalization and unwinding process is complete, but not before the restructuring begins.

In a corporate takeover that requires significant restructuring of the acquired company, new private owners will always demand majority voting control and removal of current top management who are accountable for the accumulated problems. The American taxpayer would be ill-served to receive anything less for putting in the vast amount of money needed to restructure and recapitalize these failed private entities. And the American taxpayer, just like any acquirer of distressed assets, deserves to reap the upside from their eventual resale. That basic logic is why failed banks that are too systemically important to shut down should be nationalized temporarily. That is what the Japanese government ended up doing with Long Term Credit Bank and Nippon Credit Bank, two of Japan's systemically most important banks at the start of the 1990s, and thus unable to be simply shut down.

Use government ownership and control of some banks to prepare for rapid resale to the private sector, while limiting any distortions from such temporary ownership. Nationalization of some banks is solely the damage-limiting option under the current crisis circumstances. It beats the alternative of taxpayer handouts to the banks without sufficient conditionality, leaving financial fragility undiminished. Nationalization has its costs, however, beyond the upfront money provided and risks assumed by the government. No one in their right mind wants the US or any government owning banks for any longer than absolutely necessary.[5] The Mitterand government nationalized French banks in the early 1980s as a matter of socialist ideology, not necessity, intending to keep the banks in the public sector—and that was a huge mistake. The resultant misallocation of capital interfered with innovation and discipline in the French economy, and reduced the annual rate of growth in productivity and GDP by a three or four tenths of a percent, which compounded over

[5] I have been on the record attacking state ownership and subsidization of banks in Europe for years. See, for example, Adam S. Posen, "Is Germany Turning Japanese?", Peterson Institute for International Economics Working Paper # 03-5 (condensed version published in The National Interest under the title "Frog in a Pot", Spring 2003). That is completely different than temporary bank nationalization.

several years makes a huge difference.[6] But that was an unneeded governmental takeover of viable banks kept in place for a long period. The key is that government control is kept temporary, with sell offs of distressed assets and viable bank units back to the private sector to commence as soon as possible, some of which can begin almost immediately.

The historical record suggests that this kind of turnaround is not so difficult to achieve. That is what was seen with what became Shinsei bank in Japan (purchased by American investors after Long-Term Credit Bank was nationalized and cleaned-up) as well as with the top five banks in Sweden in 1992–95. In both Japan and Sweden, most nationalized banks were re-privatized within two years, all within three. And in all these cases there were private buyers when the governments were ready to privatize the banks, something that did not exist for these failing institutions before the government undertook restructuring. As is well-known, in these cases the responsible governments made back at least 80% of their costs, in the Swedish case turning significant profits for the taxpayers.

Furthermore, these banks continued most of their day-to-day operations during the nationalization period, retaining most personnel except top management. Given government majority ownership, it is possible to set up independent management, just as boards representing owners, public or private, always delegate to managers of complex organizations. New managers could be easily brought in from the amongst the many bank executives who specialized in traditional lending and banking, and ended up on the outs when American banks emphasized investment banking and other bonus-based securities businesses in recent years. The new managers could even be incentivized properly, the way we should consider incentivizing all bank managers: with long-term stock options instead of annual bonuses (some combination of public service motivations, very high upside potential, and facing unemployment would yield sufficient numbers).

Of course, there will be some pressures for politically-driven lending, but transparency arrangements could go a long way to limiting that—and it is difficult to imagine that remaining shareholders and top management of banks in the current public-private hybrid situation would not have every (destructive) incentive to politically pander in hopes of keeping their job and their stake. The difference in efficiency and politicization of lending between the current situation and full nationalization of some banks will not be all that great (which is what was seen with the zombie banks in Japan in the late 1990s, and our Savings and Loans in the mid- to late 1980s, just pandering to politically connected borrowers in order to stay open as private concerns).

Importantly, the existence of nationalized banks in banking systems that still had private banks operating as well did not lead to excessive pressures on their private competitors, let alone significant shifts of business or deposits away from those private banks. This can be seen today in the United Kingdom where the government's large ownership stakes in some major banks such as RBS and HBOS has not led to closures of or runs on the remaining private banks; in Switzerland, where the de facto public takeover and guarantee of UBS has not noticeably harmed still private Credit Suisse; and in Germany and France, where private banking firms have continued to operate despite the ongoing presences of Credit Lyonnais and the Sparkassen as government subsidized and part-owned entities.

Again, nationalization is not cost free, for over time such public ownership arrangements do eat away at the private banks profitability and proper allocation of credit, which in turn hurts productivity and income growth. But additional inaction today regarding the fragile US banks leaving current management in charge has the prospect of rapidly adding several full-percentage points of GDP to the total of bad loans and losses in just the span of months, which is a much bigger cost. It also risks a failure of a major financial institution without warning, before the government can respond, which would have large negative repercussions in the current environment—nationalization wins out on the stability criteria as well, versus our status quo, in the short-run. Japan in 1998 demonstrated the unfortunate lesson that half-measures stopping short of nationalization backfire, when it gave the private banks more capital, only to find them running out of money and having accumulated further bad assets when a new more actively reformist government took power three years later.

Buy illiquid assets on the RTC model, and avoid getting hung up on finding the 'right price' for distressed assets or trying to get private investment up front, which will only delay matters and waste money. To complete the full restructuring of the

[6] There is a vast and empirically robust literature on the effect of differing financial systems on economic growth, led by the contributions of Jerry Caprio, Stijn Claessens, and Ross Levine, with their numerous co-authors, from which I take this simplified estimate.

nationalized banks, or for that matter even the more minor capital topping off of the viable banks, when starting from honest evaluations of balance sheets, someone has to get the bad assets off of the banks' books. The utility of so doing is widely recognized. The Treasury has proposed setting up a complicated not-bad- but-aggregator public-private entity to serve this purpose. As with the stress tests, if the current US Treasury only says such things to sugar coat a tougher less passive intent in practice, so much the better. The American government should be benefitting the taxpayer by paying as conservatively low price as possible for our banking system's distressed assets, and if that means having to increase the capital injections on one hand to make up for the write-offs from low prices on the other, in terms of net public outlay it is little different, but more of the future claims on the bad assets' value is kept in US taxpayers' hands. As Alan Greenspan has observed, if we nationalize the banks, we do not need to worry about the pricing.[7]

The Treasury's proposal for creating a complex public-private aggregator bank instead of a wholly publicly-owned simple RTC-like bad bank is motivated by two aspirations: to mobilize 'smart money' currently sitting on the sidelines to share the upfront costs of buying the bad assets; to generate price discovery about what the bad assets are really worth, particularly for illiquid assets for which there is no market. These are well-motivated aspirations, but in my opinion penny wise and pound foolish with taxpayer funds at best, and simply unattainable at worst. It is worth noting that there is no historical precedent for making such an attempt for price discovery and costs sharing with the accumulated bad assets. Simple publicly-owned RTC-like entities sufficed in the Swedish and Japanese cases, and of course in the US Savings and Loan case that set the precedent. A new and clever approach always could be an improvement in theory, but this particular one seems to share with the reverse auction ideas of the initial TARP proposal a desire to be too clever by half.

It is just as arbitrary to set prices for the bad assets by deciding how much guarantee or subsidy the private investors receive from the government to induce them to get back into the game, as it would be to go into the banks and just pay what the markets are offering or zero right now. There will not be any price discovery through private sector means by undertaking such a program because the only difference between these assets unwanted now and then is the value of the government guarantee (subsidy) on offer. Private investors are obviously not buying the distressed assets now, which they could at the current low price, so the price will be set by the amount of the US government's transfer to these private buyers. At best, this gets the toxic assets off of the various banks' balance sheets, but at a far higher eventual cost to the taxpayer than would arise if the government purchased them outright and recouped the entire upside when there is eventual restructuring of and then real demand for these assets later. It is again Congress' role to stand up for the American taxpayer, to say to the administration that they should not fear having to put up more money upfront if in the end it will save the taxpayer significant money to do so now.

At worst, employing such a complicated scheme trying to hold restructuring up until meaningful prices somehow emerge (when the only change in the assets is a government subsidy with purchase) leads to a worse outcome. Uncertainty hangs over our banking system for longer, with all the noted perverse incentives for good and bad banks that induces. Possibility of a disorderly outright bank failure persists since the illiquid assets are not rapidly moved off of the balance sheets of some of the most vulnerable banks. The US government ends up overpaying for some assets in terms of guarantees and subsidies versus simply buying them at today's low values, but only manages to sell the more liquid and attractive upside assets to the voluntary private participants. In short, the US taxpayer gets left with the lower future return lemons, while paying for the privilege of having private investors get the assets with the most upside potential. Eventually, there has to be a wholly public RTC-type bad bank anyway, but now only for the worst remaining parts of the portfolio.

A wholly public simple RTC-type bad bank approach not only avoids these risks, but offers an advantage that the public-private hybrid (again a bad idea) aggregator bank does not. In fact, the additional complexity, and thus toxicity or illiquidity, of today's securitized assets versus what our original RTC or Japan's or Sweden's faced is an additional argument for having them all be bought by the US government outright: If the US government buys most or all of entire classes of currently illiquid assets from the banks, it would have a supermajority or i00% stake in most of the securitized assets that have been at the core of our problems in this area. That would make it feasible to reassemble sliced and diced securities, going back to the

[7] Quoted in the *Financial Times*, February 18, 2009.

underlying investments (such as mortgages). This would detoxify most of these assets, making them attractive for resale by unlocking their underlying value, removing the source of their illiquidity, and thus offering the possibility of significant upside benefit entirely for the US taxpayer when sold back to the private sector. It would be an actual value-added transformation, not just an attempt to game the pricing.

In theory, a set of private sector investors or public-private partnership also could do this kind of reassembly voluntarily, but in practice the coordination problems are insurmountable, as seen in the complete lack of market for these assets at present. The use of the word 'toxic' to describe these assets leads to an apt and valid analogy: Just as the EPA can go to a Superfund site, one on which no one can currently live and no private entity is willing/able to clean up, it can literally detoxify that real estate by changing its underlying nature, and then have it come back on the market at a good value. The Treasury and FDIC can do the same with these currently toxic securities—if the US government has ownership and puts up the funding and effort to do the clean-up. Without a wholly public RTC initially owning the supermajorities, such a literal detoxification of the assets is impossible. And without that kind of fundamental change in the nature of the bad assets on the banks' books, it is difficult to see any reason for private smart money to buy them except to pick up a sufficiently large government subsidy. A hedge fund or sovereign wealth fund or private equity firm with cash is not staying out of these markets for distressed assets at present just because the prices have not yet 'fallen enough'; such investors are staying out because the assets are indeed toxic with indeterminate prices.

When reselling and merging failed banks, do so with some limit on bank sizes. One aspect of the financial crisis so far is that it has put pressure on banks and supervisors to increase concentration in the US banking system. When the government for understandable reasons will treat bigger banks as systemically important, and thus subject to bailouts and guarantees, it advantages them over smaller banks in the eyes of some potential depositors and borrowers. In addition, in each successive wave of banking fragility we have had up until now, US bank supervisors have tended to encourage stronger banks to merge with or buy up weaker banks—which is indeed in line with the standard crisis response best practice I outlined above, but also has contributed to greater concentration of the US banking system into fewer bigger businesses. The deregulation of interstate branching has also played a role. In each case, concentration was a side effect of well-motivated policies, and never became a major problem on its own terms (obviously many smaller and community banks continue to do business just fine).

We now approach a situation, however, where the US government will have capital stakes in a large portion of the US banking system, biased towards larger investments in the bigger institutions, and where there will be additional instances after triaging the banking system that seem to require mergers. Given that structural leverage over the US banking system inherent in upcoming decisions, and the sheer scale of the potential upcoming further consolidation, it is time to consciously put a limit on4his process. As Paul Volcker has pointed out in the recent G30 Report, if we get into trouble with banks being simultaneously too big to manage their portfolio risks and too big to be allowed to fail, we probably should not have banks that big.[8] This is not a matter of the normal anti-trust consumer protection against monopoly, since these developments have largely benefitted consumers on the usual pricing and choice criteria, but of other public interests at stake.

Economically speaking, there is no clear logic to encouraging banks to be as big as possible. Years and years of empirical research by well-trained economists in the US and abroad have been unable to establish any robust evidence of economies of scale or of scope in banking services. In other words, banks do not perform their key functions more efficiently or cheaply when they produce them in greater volume, and banks do not gain profitable synergies by expanding their range of services and products.[9] There was another reasonable theory that larger banks might be able to diversify their risks across a broader and more varied portfolio than smaller banks, and thus be more stable—the developments of the last two years in the US, United Kingdom, Switzerland and elsewhere, as well as those seen in Ja-

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[8] Federal Reserve Bank of Minneapolis President Gary Stern has been calling attention to this potential problem for some years now. More recently, my PIIE colleague William Cline has written about it as well.

[9] In some trivial sense, back office consolidation of certain types of processing of transactions could yield economies of scale, but even attempts to find evidence for these have proven unsuccessful—perhaps because so many of those services are available on an outsourced and competitive basis these days.

pan's highly concentrated banking system in the 1990s, however, reject that hypothesis rather dramatically (as do more formal econometric studies).

Finally, some people concerned with US economic competitiveness have argued that larger banks confer advantages, either because they allow for easier large-scale funding of US export industries, or because they allow US banks to compete better for market share in global finance, and thus export financial services. Unlike the previous two testable hypotheses, which were confronted with rigorous data analysis, these competitiveness claims have not been seriously studied. But the major threat to financing for American non-financial companies is market disruption caused by systemic bank failures, not limits on the credit available to them in normal times, and the export of financial services has been no more in the US national interest than picking any other single 'strategic industry,' a thoroughly discredited practice.[10]

So the Treasury, FDIC, and Federal Reserve should show some regard for excessive bank size and concentration in the US banking system when they are required to make decisions about banking structure upon returning parts of the system to fully private control. They cannot duck this, for even a non-decision to go with the likely outcomes of other priorities would result in defaulting to greater bank concentration at the end of the process. Unfortunately, unlike with regard to other aspects of the banking crisis resolution framework I have outlined, there is no well-established practice for how to deal with this issue.

I would suggest that two guidelines be employed: First, when any of the fully nationalized banks, which are likely to include among them some of the largest of current US banks, are brought back to market from public ownership, they be broken up, whether along functional or geographic lines. This has the additional advantage of allowing some parts of the temporarily nationalized banks to return to private hands sooner, and the return of investment to the US taxpayer also to arrive sooner. There will be some component operating units of the largest failed banks whose own sub-balance sheets can be cleaned up rather quickly. Second, preference be given to mergers of equals for the publicly recapitalized but not nationalized banks that normally would be encouraged by regulators to be merged or taken over by other banks. Since this group of banks is likely to be of a smaller average size than the nationalized group, this should be feasible. While it remains for Congress to pass regulation to determine the rules of how the US banking system should be structured in future, I believe that current law does give our bank supervisors enough authority and discretion over mergers of banks, especially for those involving a distressed institution, that this guideline can be followed when the bank clean-up moves forward in the near term (as it must).

And do all of this before the stimulus package's benefits run out. Implementing the preceding framework for resolving the US banking crisis will restore financial stability, as quickly as possible, at the lowest cost possible (though still high) to American taxpayers.[11] The experience of other countries, notably of Japan in the 1990s, but also of the US itself in the 1980s, is highly relevant to today's dangerous situation. Those historical examples show not only the right way to resolve our banking problems, but also that the rapidity and sustainability with which the US economy will recover from its present financial crisis is directly dependent upon our willingness to tackle these problems aggressively—including in some instances temporarily nationalizing banks. When the US government engaged in regulatory forebearance with undercapitalized S&L's in the mid-1980s, and when the Japanese government similarly pandered to its bankers and dawdled through the entire 1990s, the losses grew larger, and the problems persisted. When the US government truly took on the Savings and Loan crisis in 1989-1991, and when the Japanese government truly

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[10] Some top US economic officials during the 19905 and earlier this decade sincerely believed that financial liberalization was in the economic self-interest of developing countries and thus was in the foreign policy interest of the United States. That is probably valid, and I am broadly sympathetic to that view, subject to some important cautions raised by Dani Rodrik, Joseph Stiglitz and others. But some of these officials then took that to mean that promoting the export of financial services by US financial institutions, and opening of foreign markets to US financial institutions' investment and sales were in the US foreign policy—as well as export—interest. This was an unnecessary step, and one that is backfiring on the US reputation now that our financial 'model' and aggressive advocacy thereof is being blamed (excessively, but not entirely unfairly) for the current global crisis.

[11] See for example what I recommended for Japan in 2001, which was largely and successfully implemented by Japanese financial services minister Heizo Takenaka in 2002-03 ("Japan 2001: Decisive Action or Financial Panic," http://www.iie.com/publications/pb/pb.cfm?ResearchID=72). Many current senior US economic officials, such as Treasury Secretary Geithner and NEC Chair Summers, advocated the same for Japan and for the Asian countries during the 1997-1998 financial crisis there.

confronted its banking crisis in 2001–2003, following this framework, the financial uncertainty was lifted and growth was restored.

The only thing that makes the US different from other countries facing banking crises has nothing to do with the nature of our banking problems. What is special about the US in this context is the fortunate fact that we as a nation we are rich enough, with enough faith in our currency, to be able to engage in fiscal stimulus to soften the blow to the real economy while the bank clean-up is done. Emerging markets and even most smaller advanced economies generally have to engage in austerity programs, further cutting growth, at the same time that they tackle their banking crises in order to be able to pay for the clean-up. This gives us a window of opportunity, but the clock is ticking.

If we can resolve the US banking crisis in the next 18 months before the stimulus runs out of impact on the economy, the private sector will be ready to pick up the baton from the public sector—demand will grow, and recovery will be sustained. And following the common framework I have set out, it would be feasible to resolve most of our financial problems, if not return the entire banking system back to private ownership, within that time frame if we start right now. If we fail to move aggressively enough on our banking problems, this window will close because even the United States cannot afford to engage in deficit spending indefinitely—as President Obama rightly explained to Congress and the nation on Tuesday night. In that case, when the fiscal stimulus runs out, the private sector will be unable to grow strongly on its own, because the banking problems will prevent it from doing so. Japan showed us that fiscal stimulus indeed works in the short-term, but growth cannot be restored to a self-sustaining path without resolution of an economy's banking problems.

I ask the members of this Committee to carefully scrutinize and oversee the proposed programs of the US Treasury for banking crisis resolution. If those programs live up to their associated rhetoric, and are thus tough enough on the current shareholders and top management of our undercapitalized banks, we can in 2011 be like Japan in 2003, at the beginning of a long and much needed economic recovery. If unneeded complexity of the bad bank construct, excessive reliance on and generosity to private capital, and unjustified reluctance to temporarily nationalize some US banks, turn the proposed bank clean-up programs into only half-measures, then we will be like Japan in 1998—squandering national wealth and leaving our economy in continuing decline, only to have to take the full measures a few years down the road when in greater debt. I am hopeful that the Obama Administration with strong congressional oversight will do what it is need in time.

PREPARED STATEMENT OF JOSEPH R. MASON

Thank you Chairman Maloney and members of the committee for the opportunity to testify on this very important topic. I am pleased to appear before you to discuss "Restoring the Economy: Strategies for Short-term and Long-term Change." I am Joseph Mason, Hermann Moyse, Jr./Louisiana Bankers Association Professor of Finance at Louisiana State University and Senior Fellow at The Wharton School, and these are my personal views.

The Committee asked panelists to opine on both short- and long-term changes that can help restore the economy. The written testimony that follows outlines three primary suggestions in each regard, focusing on financial market reforms that set the stage for economic growth. The macroeconomic understanding of financial crises is that they do not cause recessions, but merely prolong and/or deepen them. Recessions are therefore possible without a financial crisis, but once an economy is in recession, recovery is virtually impossible with a financial crisis. Until the crisis is resolved, therefore, fiscal and monetary policies push on a string.

In the short-term, resolving the crisis will require humility and hard work. The United States still has the most advanced financial system in the world, but the crisis resulted because the system got too far in front of regulatory capabilities. Among the key weaknesses that caused the crisis are classic problems like banks that consider themselves too-big-to-fail, insufficient accounting transparency to support regulatory and investment needs, and textbook asset market overhang in housing markets. Luckily, those problems are relatively easy to resolve in the short run, even if doing so will take courage and flexibility. While existing policy attempts to address some of these issues get close to helping, slight changes in approach can achieve success in a much more straightforward and effective manner.

The long run will be much harder, requiring significant efforts to fix old and build new regulatory structures and set the stage for U.S. economic growth. Much of the work will not be glamorous. Before one brick can be laid in the new financial structure, there needs to be a discussion of basic regulatory principals that will serve as the mortar of the construct. Much additional work will lie with international bodies, wherein I expect participants will build upon existing unitary principals of oversight laid down nearly two decades ago to develop standards and procedures for resolving failed financial institutions, providing bridge financing and oversight, and disposing of their assets. Global imbalances in economic growth potential are already spurring the development of trade blocs and agreements worldwide, presenting both opportunities and threats to U.S. markets. U.S. diplomacy abroad will go a long way toward smoothing some of those sentiments, and regulatory changes at home can help U.S. businesses adapt strategically to fast-moving changes in global markets and stay competitive.

The unifying theme of all of my suggestions is restoring credibility to the U.S. financial system. Out of every crisis, it must be recognized, arises an opportunity to improve. The objective at the end of the exercise—which may be decades away—must always be kept in sight: set a firm foundation for improved financial markets and economic growth potential so that the necessary restructuring becomes known more for its own success than the crisis that spurred us to action.

I. Restoring the Economy in the Short-run: Resolving the Financial Crisis

As mentioned above, the key problems of the current credit crisis are banks that consider themselves too-big-to-fail, insufficient accounting transparency to support regulatory and investment needs, and textbook asset market overhang in housing markets.

A. End Too-big-to-fail

The too-big-to-fail doctrine has been around for some twenty years now and has yet to be resolved. The latest incarnation has been justified by "systemic" importance of some institutions over others. Systemic importance, however, is a specious and potentially disingenuous concept. There is no accepted definition of systemic risk, save that which points to a fundamentally unquantifiable transmission of risk through the financial system, akin to contagion.

Unlike contagion, however, there need not be a non-fundamental mechanism at work in systemic risk—merely one that is left unmonitored so that it passes risk to the entire financial system. Hence, to an aggressive systemic risk regulator, everything is likely to look like systemic risk. Moreover, markets with systemic risk protection will find little need to monitor counterparty exposures, creating severe moral hazard conditions. (See, for instance, Peter J. Wallison, "Casting the Fed as a Systemic Risk Regulator," AEI Financial Services Outlook, February 24, 2009).

Indeed, the "systemic" nature of today's problems lies only in the degree to which large banks managed to enter business arrangements that banks and regulators, alike, were reluctant to monitor. Today, there are two big impediments to placing insolvent banks in receivership, thereby prompting claims of too-big-to-fail. First, regulators would have to acknowledge that they did not understand the extent or importance of bank off-balance sheet commitments. Regulators expressly allowed contracts to be written that are triggered by receivership, but now does not know which and how many or who will gain and, especially, who will lose if the institutions fails. In reality, the situation may be more similar to that of Continental Illinois in 1984, when the OCC said it feared spillover that would cause many banks to fail—a fear that was later revealed to be grossly exaggerated. Regulators today do not have the necessary information not because it is impossible to obtain, but because they have not heretofore sought such information, reasoning that off-balance sheet arrangements did not matter. Future crises are therefore probably not best avoided by allowing a systemic risk regulator to stand ready to make excuses for regulatory laxity.

Second, and equally important, regulators today have not yet managed to transfer servicing rights successfully out of a failed institution. Mortgage bank failures in the late 1990s followed an almost identical path to the larger-scale disruptions we are seeing today. Failure typically occurred at the end of a chain of events wherein subprime mortgage providers lowered underwriting standards to fuel growth. The resulting diminished loan quality, however, hurt their securitizations and resulted in financial losses in both on- and off-balance sheet arrangements. Struggling to survive without securitization, firms flooded the whole loan sale market, causing precipitous declines in whole loan prices. Stock prices of subprime lenders plummeted and highly leveraged companies could not repay debt. Without funding sources other than securitization, financially stressed issuers had no alternative but to file Chapter 11. By the end of the decade, few subprime originators remained. (Moody's, "Bullet Proof Structures Revisited: Bankruptcies and a Market Hangover Test Securitizations' Mettle," 20020830 at 12.)

Both off-balance sheet risks and servicing rights transfer difficulties are known-unknowns, known by the industry but "unknown" by regulators. Merely ignoring risk does not make it systemic once the denial becomes evident.

Today we all know a great deal more about bank operations and values than we did previously. Even without resorting to custom-designed stress tests (which cannot be developed to deliver any useful degree of accuracy in a matter of weeks, but take years to parameterize), we know that there are three classes of banks in the system right now: the insolvent; the marginally solvent; and the solvent. Policy needs to focus on relieving the economy of the value-destroying loans produced by the now-insolvent banks, financially and operationally restructuring the marginally solvent banks, and building economic growth upon the lending platforms of value-creating solvent banks.

Insolvent banks—regardless of their purported systemic importance—are value destroying institutions that need to be closed. If insolvent banks were car companies, they would be relying on worn machinery and ill-trained staff to produce East-German Trabants that break down as soon as they leave the production line. In fact, the loan products these banks created did break down almost immediately after they were produced, in that they exhibited early-payment defaults and often involved payments and fees that the borrower could not afford. The mortgage delinquencies we see today are therefore the result of faulty management, bad supervisory systems, ineffective proprietary software, and ill-targeted employee training, not mere exogenous economic shocks, and the banks that produced those products are insolvent as a result. Insolvent institutions therefore need to be shut down in the public interest: while the economy needs loans to fuel economic growth it needs high-quality value-creating loans that borrowers stand a chance of repaying, not value-destroying loans that disrupt economic activity even further.

Marginally solvent banks face difficulties, but maintain some redeeming assets that suggest they possess going concern values worthy of being maintained. That is, the majority of marginal bank portfolios consist of value-creating loans that benefit economic growth. Government recapitalization programs with appropriate limits on management and insistence on institutional reforms can possibly, therefore, benefit marginally solvent institutions and present a chance of supporting economic growth by creating, rather than destroying, value.

Still, merely stabilizing marginally solvent banks will not support growth. To fuel growth, solvent institutions needing neither government assistance nor intervention can utilize government funds to finance the purchase of failed-bank assets to relieve asset market overhang as well as make new loans. To deny solvent institutions additional capital to address the economic situation is to penalize them for creating economically value-creating assets. Policy needs to focus, therefore, on relieving the economy of the value-destroying loans produced by the now-insolvent banks, restructuring the marginally solvent banks, and building upon the existing value creating business platforms of solvent banks to foster sound economic growth.

In summary, it is crucial to dismantle the too-big-to-fail doctrine for the good of the American banking system. No firm is ever too-big-to-fail. While some firms may be too misunderstood for regulators to effectively manage the failure and subsequent disposition of assets, the misunderstanding is fundamentally different from too-big-to-fail and not an excuse worth of justifying a lasting or fundamentally irreconcilable systemic risk exemption. Hence, other short-term policies address transparency so that the firms can be better understood and flexible means of asset disposition policy that have been heretofore overlooked.

B. Increase Investor and Regulatory Transparency

The key problem with financial markets right now is that commonly-produced standardized financial ratios are meaningless. Without information, investors do not know the value of their holdings, cannot sell those holdings, and cannot rationally allocate funds derived from those sales if they could.[1] Without funds, firms cannot invest in new projects that create economic value—that is, jobs, income, and economic growth. Nonetheless, existing policy proposals have all been about suppressing information: information about bank conditions, about other sources of risk, and even about government programs meant to address the situation.

[1] . . . and with interest rates near zero have no incentive to look very far for opportunities to sell, anyway.

Unfortunately, financial reporting is thought of as an excruciatingly boring policy topic.[2] More unfortunately, however, financial reporting is crucial to any well-functioning financial system. Without restoring financial reporting, we cannot hope to end too-big-to-fail (nay, too-misunderstood-to-fail) and we cannot expect to reinvigorate investment and economic growth.

The breakdown of financial reporting began with off-balance sheet regulatory arbitrages affected in the early 1990s in response to Basel I.[3] As bank conditions began to be evaluated on the basis of a capital/asset ratio on the tail end of a recession, banks seeking to raise their capital/asset ratio faced with the dilemma of whether to raise capital or reduce assets at a time when capital was prohibitively expensive. Hence, most sought to reduce assets through securitization, instead.

Often, however, the lion's share of risk was not transferred in the securitization. Rather, sellers retained first-loss residual and mezzanine interests in the loans and offered further representations and warranties supporting the sale. Some of those representations and warranties were explicit, some implicit. Implicit representations and warranties are now referred to by the industry as "reputational risk," which has been cited as the reason some sellers repurchased entire deals of SIVs and ARSs, as well as other investments, in the past year.

As discussed in my Senate Banking, Housing, and Urban Affairs Committee (Subcommittee on Securities, Insurance, and Investment) testimony from September 18, 2008, as early as 1987, Moody's pointed out that, ". . . the practices developed by the accounting and regulatory world . . . do not fully capture the true economic risks of a securitized asset sale to the originator's credit quality." (Moody's Investors Service, "Asset Securitization and Corporate Financial Health," December 1987, p. 3) Hence, long ago market insiders fully realized that standard accounting rules do not apply to securitizing firms.

In 1997, Moody's Investors Service wrote that, ". . . the simple act of securitizing assets can affect the appearance of the income statement and balance sheet in a profound manner without, in many cases, significantly altering the underlying economics of the [seller]." (Alternative Financial Ratios for the Effects of Securitization, Moody's Investors Service, September 1997, p. 1) With securitization, therefore, reported earnings are overstated and reported balance sheet leverage is understated while there may be little, if any, risk transference.

Moreover, it became common over time for sellers to voluntarily provide informal support to preserve the performance and bond ratings of their structured transactions. (Moody's Investor's Service, "The Costs and Benefits of Supporting "Troubled" Asset-Backed Securities: Has the Balance Shifted?" January 1997) As the practice became accepted by regulators and the marketplace, ratings agencies could indeed rate any of these bonds AAA without reference to fundamental loan pool characteristics or securitization structure because any seller with going concern value would support the pool to maintain its "reputational risk" so it could issue again next period. Of course, it would be egregious to maintain that securitization transfers no risk at all. As we have seen recently, in the event of catastrophic asset quality problems the seller may choose NOT to support a troubled deal, notwithstanding even any legal—much less reputational—responsibility to do so. That is why investors right now want to know how much more is out there in off-balance sheet exposure that can still threaten the firm's ability to "reputationally" support their securities. Unfortunately, those answers are not easily found, even for professional investment analysts.

Those off-balance sheet arrangements were also the first to utilize mark-to-market (really, mark-to-model) accounting features under the guise of gain-on-sale accounting. Gain-on-sale accounting led to tremendous industry disruptions in the late 1990s. FASB'S August 11, 2005, Revision of Exposure Draft Issued June 10, 2003, "Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140," (Financial Accounting Series No. 1225-001), explains gain-on-sale roughly as follows: In order to facilitate "gain-on-sale accounting," the firm (1) estimates the value of the thing they want to sell with a financial model. Then, the firm (2) receives some money and other items in the actual sale of that thing. Next, in what is the really arbitrary aspect of gain-on-sale accounting, the firm gets to (3) record the difference between their own valuation of the thing that they sold and the value of the cash and other items received in the sale as cash revenue.

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[2] Only the chair and ranking member attended Senate Banking, Housing, and Urban Affairs Committee, Subcommittee on Securities, Insurance, and Investment hearings on FASB reform on September 18, 2008.

[3] Some also note the use of securitization to avoid interest rate risk in the 1980s. While that purpose was certainly useful, securitization did not really take off until the regulatory arbitrage became valuable.

Difficulties in the high-LTV home-equity loan crisis of the late 1990s were largely attributable to aggressive gain-on-sale accounting. According to Moody's:

In the late 1990's, several subprime home equity and auto lenders encountered financial difficulty arising in part from explosive growth patterns, in part from using securitization as a source of funds, and in part from overly aggressive use of gain on sale accounting. Such accounting methodology made these companies look much stronger financially on paper than they actually were. Companies that used gain on sale accounting included, among subprime mortgage issuers, Contifinancial Corp., Southern Pacific Funding Corp., Cityscape, and United Companies Financial Corp. . . . Once the effect of gain on sale accounting was removed from financial statements, leverage ratios were often high. These companies also had weak capital positions compared to more diversified finance companies. (Moody's Investors Service, "Bullet Proof Structures Revisited: Bankruptcies and a Market Hangover Test Securitizations' Mettle," August 30, 2002, p. 14)

The problem with gain-on-sale accounting, therefore, is that the revenue booked is not real cash. Hence, many recently-failed mortgage companies and similar firms associated with previous securitization fiascos have never been cash-flow positive in their entire corporate lives. When firms, realizing the risks of gain-on-sale accounting and the false earnings conditions they represented to investors, sought to pull back from gain-on-sale and become more conservative, they were told by FASB that any willing conservatism would be considered earnings manipulation. Thus, the financial world was recently littered with hundreds of firms with exceedingly high stock values that had never actually earned positive cash profits in a manner typical of a classic bubble.

Both off-balance sheet exposures and mark-to-market accounting argue for a more robust financial reporting environment than is that envisaged by the Financial Accounting Standards Board (FASB). In the Senate Banking, Housing, and Urban Affairs Committee, Subcommittee on Securities, Insurance, and Investment hearings on FASB reform on September 18, 2008, FASB abjectly refused to even consider advocating any deviation from an accounting system based on a single value for any particular item or firm. But in an off-balance sheet world of contingent claims and statistically modeled values for level 2 and 3 "mark-to-market" assets, a single value is not only inadequate, it is grossly misleading.

Investors want to know the entirety of off-balance sheet exposures right now—knowing that the commercial banking industry is leveraged not at the 12:1 reported on balance sheet, but at roughly 185:1 off balance sheet—but are not able to get the information from existing sources.[4] That does not mean that FASB should reverse policy and disallow off-balance sheet treatment, putting off-balance sheet exposures completely back on-balance sheet, only that the off-balance sheet exposures need to be completely and systematically reported somewhere in the financial statements.

But investors also want more. Investors also want to know the range of statistical model values that can be reasonably expected to apply to level 2 and 3 assets—that is, the standard errors of the estimates. Such ranges will allow investors to "stress test" firm financial characteristics on their own, in a clearly transparent way without being filtered through Treasury's secrecy and interpretation.

It is important to realize that the investors I have been talking about include all bank "counterparties." Outside investors today can evaluate banks no better than banks can evaluate one another's counterparty risk. Hence, transactions have shut down in today's opaque financial reporting environment. Guarantees and other second-best solutions will only alleviate counterparty risk concerns as long as the guarantor (even the Federal government) remains willing, credible, and solvent. Hence, the key objective has to be to restore financial market transparency as soon as humanly possible so that markets can once again work without the aid of outside guarantees.

C. Deal with Asset Market Overhang

The above discussion of financial reporting suggests that even if financial market prices are well-established, they are not presently communicated through credible financial reporting mechanisms. In today's housing markets, however, values of

[4] Even SEC Regulation AB was arbitraged when banks hid the required information on the internet. Try working with the following link (not linked to any of Countryside's corporate web site and with no main page to change reporting periods or otherwise run scenarios an investor might be interested in) for some of the data behind Countrywide's deals: http://www.countrywidedealsdata.com/RegABDealList.aspx?CWDD=01200804.

foreclosed and vacant houses are far from certain. Hence, alleviating the stock of unsold and unoccupied homes in today's housing market should be a key concern. Unfortunately, dogmatic "home ownership" policy and archaic bank regulations stand in the way of quick recovery. If we view the housing crisis as merely one of occupancy rather than ownership, policy solutions are readily at hand.

The common understanding of the problem is that foreclosed homes are dumped on the market at fire sale prices and those prices push values down in surrounding neighborhoods.[5] But while focusing on the foreclosure part of the problem we are missing the important part: the fire sale that pushes down prices. Fire sale prices result not because lenders want to sell at a loss, but because lenders—usually commercial banks—are prohibited from managing the real estate except for the brief period of time during which it is on the market.

Consider what would happen if the bank could rent the home out and wait for market recovery. The bank would replace the cash flow from the loan with a slightly lower cash flow from rental income. While the bank would still book losses from legal costs and a lower rental income cash flow, fire sale losses could be avoided. Lastly, the bank can sell the home in the market upturn several years hence and possibly recoup some of the losses in the failed loan.[6]

Consider the additional social advantages if the bank could rent the home to the existing occupants. If the financial conditions of the renter improved with economic recovery, the bank may also have a ready buyer in the existing occupant, as well. Occupants would have more of an incentive to maintain the property and foreclosed owners would have less incentive to destroy the property in reaction to bank actions. Occupants would most likely buy the house back from the bank at a market-determined value later on, relieving the need for government guess work in the middle of a crisis.

Such regulatory changes are a simple way to ensure that home owners affected by the crisis do not get hurt again, something current modification proposals do not adequately address. In fact, forthcoming research shows that many companies claiming to be special servicers—but really run by the same managers that owned failed subprime mortgage companies—are already entering the business to fleece borrowers and collect the $1,000 per head fee offered under the most recent housing plan. Even worse, modification frauds have proliferated throughout the country, preying on the same uninformed consumer that got the unaffordable subprime loan.

The fact is servicer quality matters, and servicer quality matters even more when loans become distressed. A defaulted borrower that re-establishes payment on their loan usually does so because of some element of trust between them and the servicer that leads to establishing a payment plan the borrower believes is advantageous to both parties. The servicer may work on the borrower's behalf as part of that plan, assembling a program combining elements of bankruptcy, selling other assets, or consolidating other loans. If the borrower is still unable to make the payments, the servicer maintains a good relationship with the borrower through the foreclosure process to preserve the value of the home and liquidating the collateral to collect money owed to the investor. (Fitch, "Scratch & Dent: This Is Not Your Father's MBS," 20051213 at 8)

But the servicing industry already has a checkered past. In the 1990s subprime mortgage servicers were plagued with problems: aggressive growth strategies led to expanded underwriting guidelines; a significant increase in correspondent lending led to inflated property appraisals; and predatory practices both in underwriting and servicing led to rampant lawsuits. Many of the players that were market leaders—such as ContiMortgage, IMC Mortgage, United Companies, and The Money Store—went out of business long ago. (Fitch, "Rating U.S. Residential Subprime Mortgage Securities," at 1)

According to Elizabeth McCaul, former Superintendant of Banks for the State of New York, some areas of weakness in the servicing industry in recent years leading up the present crisis included ". . . a lack of focus on the strength of the originator/servicer, and improper analysis of the substitution of good loans for bad. We have seen re-aging policies not being properly analyzed. In fact, investment in this area has been largely driven by mathematical formulations without enough qualitative analysis of operations and financial strength. For example, we have conducted reviews of portfolios and seen residuals on balance sheets that do not reflect enough financial strength to continue operations effectively. If the shop is closed, the Trust-

[5] Although I do not need to go into it here, the common understanding is flawed: a foreclosed home is often of lower value than an occupied home because it has deteriorated in condition due to lack of maintenance and sometimes willful destruction of the previous occupants.

[6] Bank ownership could be limited to seven years to ensure that banks do not end up being primarily real estate development companies.

ee comes in, the re-aging practices (and other practices) are halted. . . delinquencies roll in, and the rest, as you know, is history." (McCaul, Elizabeth, "What's Ahead for the US Residential Mortgage Market," Speech at ASF 2007 conference by Elizabeth McCaul of Promontory Capital, former Superintendent of Banks for the State of New York, February 2, 2007 at www.SIFMA.org)

According to Bank of America, "Payment deferral will not help people who inflated incomes or recklessly bought properties they could not afford (by some estimates, 70% of stated income loans contain inflated by 50% or more)." (Bank of America, "Subprime Mortgage Finance Weekly: Subprime Loan Modifications—not a Panacea," May 25, 2007, p. 4.) Deferring payments for such borrowers may just squeeze the last pennies out of the borrowers' pockets. If the borrower has no true hope of owing the home, even with the deferment plan, the program may be judged to be predatory. Even if such remedies are targeted across the pool of borrowers evenly, if protected class members adversely select to participate in such programs the outcome could be judged to harbor disparate impact. Worse yet, if the borrower does not maintain the house or destroys the house knowing that they cannot truly afford the home, the ultimate loss in foreclosure is larger than if the lender had foregone the mitigation. (Mason, Joseph R., Mortgage Loan Modification: Promises and Pitfalls, October 3, 2007. Available at SSRN: http://ssrn.com/abstract=1027470) Hence, according to Moody's, modifications that are used properly are obviously a very good tool. But, ". . . the one thing you don't want to do is to defer the inevitable."

The investor (and borrower) is therefore at the mercy of the servicer who is making a ". . . judgment call as to whether a mortgage is salvageable or not, and that varies depending on market conditions," as well as personal conditions of the borrower and their intentions. (Moody's, "Sub-Prime Mortgages: An Integrated Look into Credit Issues Today and What to Expect," Transcript of a teleconference held on Friday, 9 March 2007 at 16; Mason, Joseph R., Mortgage Loan Modification: Promises and Pitfalls, October 3, 2007. Available at SSRN: http://ssrn.com/abstract=1027470)

Moreover, that judgment call is made with virtually no direct oversight. In most cases, prior to a servicer's default, the is trustee not required to investigate accuracy of information stated in any document it receives, unless it receives a written request from insurers or holders of minimum percentage of outstanding certificates to do so. Of course, a conundrum arises because insurers and investors have little reason to assume such a written request is necessary without some investigation of the accuracy of information in the documents. The point is the investor has to completely trust the servicer to act on their behalf, often in substantially unverifiable dimensions. (Heller-Ehrman, "The Subprime Mortgage Crisis-Overview of Civil Litigation Claims," Presentation from Navigating the Credit Crisis Conference, Wednesday, March 5, 2008)

Even if the trustee were to undertake such an investigation, however, the standard of service required of the contractual arrangements is vaguely defined. Typical provisions require the servicer to follow accepted servicing practices and procedures as it would employ "in its good faith business judgment" and which are "normal and usual in its general mortgage servicing activities" and/or certain procedures that such servicer would employ for loans held for its own account. (Heller-Ehrman, "The Subprime Mortgage Crisis-Overview of Civil Litigation Claims," Presentation from Navigating the Credit Crisis Conference, Wednesday, March 5, 2008)

Servicing, therefore, is a crucial aspect of value to all consumer loan securitizations but it is not very well understood by regulators or investors. The problem is that servicer accountability and reporting to investors and regulators is woefully inadequate. Adequate information to evaluate servicer quality rarely exists, and where it does it is not consistently or widely distributed. Hence, regulators can do a great service to both the industry and borrowers in today's financial climate by insisting that servicers report adequate information to assess not only the success of major modification initiatives, but also overall performance. The increased investor dependence on third-party servicing that has accompanied securitization necessitates substantial improvements to investor reporting in order to support appropriate administration and, where helpful, modification of consumer loans in both the public and private interest.

II. Restoring the Economy in the Long-run: Building Tomorrow's Growth

While the key challenge to implementing the short-term elements above are primarily inflexible dogma and courage, the challenge to long-term elements will be that of staying focused on the problems long after the crisis has passed. Nonetheless, fundamental changes to domestic and international regulatory structures will be key to maintaining U.S. financial market competitiveness, and policies that can streamline productivity gains through removing outmoded regulations and other impediments to growth can help increase U.S. economic competitiveness overall. Again, however, I cannot stress enough that focus will be the key. Hence, the short- and medium term need to be devoted to setting a foundation of shared bipartisan understanding of the issues the policies that need to be addressed. Only with a foundation of genuine shared understanding and agreement can the policy discussion last long enough—most likely this will take several political administrations—to reach meaningful solutions.

A. Lay Down a Firm Foundation for Domestic Regulatory Structures

Using the analogy of the "financial architecture," the primary foundation lies in the fact that even the best architects cannot expect to create buildings that plumbers, electricians, and carpenters cannot build. Certain physical limitations of the financial system need to be addressed on a mundane fundamental level before we can think about the form of the regulatory system that we expect to arise. Changing titles of key regulatory officials, in the manner of a typical corporate reorganization, will not lead to effective change. As James Aitken of UBS is fond of saying, "start with the plumbing." To that I would add that not only is the plumbing the hardest thing to change afterward, but flow is a natural concept that is impossible to fight and back-ups really stink!

The starting point is the basic concept of and appropriate role for financial regulation. There will always be a portion of the financial system in which highly risky products are traded with freedom and there should always be a portion where risk is kept within certain well-monitored acceptable levels. Hence, there will always exist a continuum of regulated and unregulated institutions (whether we like it or not—black markets work, too). If we push regulation to hitherto unregulated institutions, new unregulated institutions will be developed to operate in the unregulated portion of the continuum. Hedge funds arose in this regard, and new institutions will develop behind them.

That starting point leads to the recognition that one key principal violated in the recent crisis is akin to the gravity that causes water to flow downhill: while it is fine for non-regulated financial institutions to invest and fund themselves via regulated institutions, if the system allows regulated institutions to fund themselves and invest in non-regulated products you have a recipe for disaster. We should want risk to travel from regulated to non-regulated firms, but we should try to prevent risk from travelling the other direction. When banks funded lending via private unregulated securitization markets, banks began to rely crucially on a set of unregulated financial institutions that were not fully developed and are therefore prone to volatility and upset—the recipe for the disaster we are seeing.

That leads to a second observation: risk never goes away. Pooling loans to serve as collateral for a securitization does not create diversification any more than buying more shares of the same firm. Tranching mortgage- or asset-backed securities also does not reduce risk, it only moves it to the most junior bond claimants—usually the banks, themselves, that hold the residuals and mezzanine stakes.

The point is that in a world based on financial engineering, risk is increasingly fungible. For instance, where risk seems to disappear on a contractual basis, it reappears on a reputational basis. It is straightforward, therefore, to propose that reputational risk is valuable. Moreover, however, reputational risk is fairly easily defined in terms of game theory: reputational risk exists when there is a cost of cooperating and that cooperation is necessary to continue the game to the next period (i.e., bailing out securitized investors like those in SIVs and ARSs). It is straightforward to propose, therefore, that firms should hold capital to cover the probable cost of cooperation.

The starting points of acknowledging roles for risky and less risky institutions and the evolution of institutions to meet market needs also lead to an acknowledgement that financial innovation will always be with us. Hence, we need a system flexible enough to monitor new developments and relate their importance to the gravity and fungibility conditions discussed above. From 2001 through 2008, Mark Adelson (now at S&P) archived panel notes at structured finance industry conferences around the world that described how the industry has long been concerned with many of the issues that are causing the present crisis. (see http://www.adelsonandjacob.com/publications.html) Regulators, however, failed to listen to discussion within the industry, choosing instead to ignore the developments until the scale of difficulties rose to a national economic crisis that demanded their attention.

This failure to monitor financial innovation and new financial institutions—along with the specious nature of the currently proposed systemic risk regulatory approach—leads to consideration of a much more effective monitoring role for all regulatory agencies, tracking innovation and new financial institutions to ensure that they do not move unregulated risk into regulated institutions by transforming it into previously unmonitored forms.

Finance is a fast-evolving field. Financial regulators therefore need to be proactive in their approach, so that they are not "surprised" enough for unmonitored risks to become anything that could even loosely be considered "systemic" in the first place.

B. Start Building a More Comprehensive International Regulatory Structure

Currently, other dogmatic and inflexible approaches are driving a wedge between European and U.S. regulation, and both are leaving the rest of the world behind. Instead, it makes sense in an increasingly global world to work with other countries to further develop unified standards set under the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) that can deal not only with prudential supervision of banks in particular, but financial institutions and their failures more generally.

According to the Federal reserve Bank of New York, foreign banking institutions, which include foreign bank branches, agencies, and U.S.-chartered bank subsidiaries, hold approximately one-fourth of all commercial banking assets in the United States. In December 2006, foreign banking organizations operated or controlled 188 branches, 133 agencies, 62 U.S. commercial banks, and 8 Edge or Agreement corporations. Foreign banking institutions held about $216 billion in commercial and industrial loans, roughly 18 percent of the total in the United States.

FBSEA laid down responsibilities for prudential supervision of foreign banking institutions largely in response to the Bank of Credit and Commerce International (BCCI) scandal, in which it was found that no regulatory agency took responsibility for BCCI's prudential supervision. FBSEA laid down rules of assigning prudential supervision authority among different countries. FBSEA also stipulated that although branches may receive deposits of any size from foreigners, they may accept deposits only in excess of $100,000 (wholesale deposits) from U.S. citizens and residents.[7] Similar provisions exist across European countries, limiting domestic deposit insurance liabilities to foreign depositors.

Unfortunately, FBSEA has remained frozen in time as the global financial system has changed. In fact, we have learned from the current crisis that while it is important to limit deposit insurance fund liability across borders, it is equally if not more important to deal with asset resolutions across borders. For instance, with some 18 percent of U.S. commercial and industrial loans, the failure of a foreign bank can have dire ramifications for U.S. businesses. Furthermore, in the event of a deposit insurance payout at the foreign bank, foreign deposit insurance authorities' dealings with U.S. borrowers could be important to U.S. regional or national economic performance. Even more complex, will foreign bank U.S. asset proceeds be used to pay amounts due to U.S. depositors, or do those satisfy foreign bank home country insured depositors first?

Resolving global financial crises in a global marketplace means coordinating regulatory approaches to sell banks and bank assets across borders. Hence, we need to develop a Foreign Financial Asset Resolution Enhancement Act to effectively deal with other countries' regulatory systems that manage both bank and non-bank assets and smooth regulatory frictions that can interfere with orderly resolutions of financial assets, worldwide. This initiative becomes more crucial day by day, as too-big-to-fail becomes too-big-to-save when financial institutions become larger than not only their safety nets, but also their home country domestic economies.

C. Increase U.S. Economic Competitiveness

All of the above initiatives ultimately increase U.S. economic competitiveness. Increased international diplomacy regarding foreign bank resolutions can also create ties that break through foreign nationalist pressures and nascent trade blocs that are developing as countries try to insulate themselves from the global crisis. Those diplomatic efforts will help to maintain trade patterns that foster U.S. manufacturing and therefore economic growth.

Smart regulation in the financial sector will reduce unnecessary impediments to growth in U.S. financial markets, maintaining U.S. preeminence as having the most transparent and efficient markets in the world. Undertaking a broad-based review of the U.S. financial reporting will reveal obvious avenues for improvement—such as changing bank regulatory call report classifications for brokered deposits and de-

[7] Furthermore, as a result of the FBSEA, deposits in any foreign bank branch established after December 19, 1991, are not covered by U.S. deposit insurance; deposit insurance is now offered only to U.S.-chartered depository institutions. Foreign agencies specialize in making commercial loans to finance international transactions, and they may accept only short-term deposits related to such transactions.

veloping increasingly relevant consolidated bank holding company-level Y-9 reports of off-balance sheet risk—that will lead to more sensible regulatory rulemaking in the new financial marketplace.

III. Summary and Conclusions

This written testimony offers three primary suggestions for short- and long-term strategies to restore the economy and fostering long-term growth. Again, my testimony focuses primarily, but not exclusively, on financial market reforms. The reason for that focus lies in the macroeconomic understanding that financial crises do not cause recessions, but merely prolong and deepen them. Recessions are therefore possible without a financial crisis, but once an economic is in recession recovery is virtually impossible with a financial crisis ongoing.

As stated above, in the short-term, resolving the crisis will require humility and hard work. The United States still has the most advanced financial system in the world, but over the last several decades the growth of that system outpaced U.S. regulatory capabilities. Among the key weaknesses that caused the crisis are relatively well-understood shortcomings like too-big-to-fail, insufficient accounting transparency, and asset market overhang. We already have several decades of economic research that we can use to resolve those problems in the short run, even if doing so will take courage and flexibility. Nonetheless, while existing policy attempts to address some of these issues get close, slight changes in approach can achieve success in a much more straightforward and effective manner.

For instance, the House introduced Bond Rating legislation as HR 6482 last summer, but that bill was not put to vote due to the financial market crises of the period. Such legislation will be crucially important to moving the industry forward. But even dogmatic shifts such as focusing on the far more obtainable goal of housing occupancy instead of home ownership can help get our economy moving quickly again with a lower probability of home buyers getting hurt again.

As stated above, reform in the long run will be much harder, requiring significant efforts to fix old and build new regulatory structures and set the stage for U.S. economic growth. Much of the work will not be glamorous. Before one brick can be laid in the new financial structure, there needs to be a hard discussion of regulatory principals that will serve as the mortar of the construct. Much additional work is necessary to develop international diplomatic relations around existing unitary principals of oversight to develop standards and procedures for resolving failed financial institutions, providing bridge financing and oversight and disposing of their assets. Global imbalances in economic growth potential are already spurring the development of trade blocs and agreements worldwide, presenting both opportunities and threats to U.S. markets. U.S. financial diplomacy abroad will go a long way toward smoothing some of those sentiments, and U.S. businesses will have to adapt strategically to fast-moving changes in global markets to stay competitive.

The binding principals of any regulatory reform process—which is a large part of what we have at hand here—are "do no harm" and "leave the industry cleaner than when you arrived." Hence, we have before us both the opportunity and motivation to improve our economy and our nation. Let us embark on setting a firm foundation for improved financial markets and economic growth potential so that the necessary restructuring becomes known more for its own success than the crisis that motivated the changes.

In conclusion, it is fitting that today's panel includes the Honorable Paul Volcker, who Chaired the Federal Reserve at a time when we first learned of "natural rates" in economics. We learned then that attempts to push unemployment below natural levels creates perverse economic dynamics, like stagflation. The recent push to drive home ownership rates to one hundred percent and substitute debt for income has had similar perverse effects. As Chairman Volcker showed us back then, the only way out of the perverse dynamics is to move through the downturn. I hope we learn form Chairman Volcker's example and exhibit the courage to book the losses, learn our lessons, and move back to meaningful and robust economic growth.

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