

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

Before the House Financial Services Committee

*"Experts' Perspectives on Systemic Risk and Resolution Issues"*

September 24, 2009

---

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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