VIII. Additional Views

Richard H. Neiman

I am pleased to support the Panel's special report on regulatory reform, which begins to address some of the most critical issues facing our nation, such as improving consumer protection, reducing systemic risk, eliminating regulatory gaps, and enhancing global co-ordination of supervision. These are precisely the issues we need to address in these unprecedented times, when Americans are losing their homes, and the financial system and our economy are at greater risk than at any time since the Depression.

Addressing any one of these issues individually would be a challenge; compiling a report that addresses them all within nine short weeks was a herculean task. Given the diversity of backgrounds and ideological views of the panel members, the fact that we have reached agreement on the critical issues and on many action items to address those issues is truly remarkable.

As the only regulator on the panel, I find it appropriate to highlight certain issues of particular importance and to which I bring a unique perspective.

- STATES MUST BE ALLOWED TO INCREASE THEIR ROLE IN PROTECTING CONSUMERS

States have long strived to protect their citizens from harmful financial products and should continue to carry out this vital role. States, like New York, sounded an early alarm on subprime lending by adopting anti-predatory lending legislation and reaching landmark settlements with the nation's top mortgage bankers, providing hundreds of millions of dollars in consumer restitution and improving industry practices.

Rather than join with the states, however, the OCC and the OTS thwarted state efforts, by claiming broad field preemption and then failing to adopt measures that protected consumers. This federal overreach caused gaps in consumer protection standards, as more protective state laws were set aside without being replaced by appropriate national standards or equivalent enforcement efforts.

I want to underscore the Panel's recommendation to eliminate federal preemption of state consumer laws and confirm the ability of states to examine and enforce compliance with federal and state consumer protection laws. The recommendations will restore the appropriate balance between federal and state regulators and provide the basis for a "New Federalism." It will draw on what is best about our current dual banking system, close gaps in consumer protection, and maximize the effectiveness of the joint resources of state and federal regulators.

- THE FEDERAL RESERVE BOARD SHOULD SET MINIMUM FEDERAL STANDARDS FOR CONSUMER PROTECTION

The Panel's report calls for the establishment of a single federal regulator that would have overarching consumer protection responsibilities, such as setting national minimum standards. We need to establish adequate baseline consumer protections for all Americans. Under this proposal, states could adopt more stringent requirements than the federal body, as local conditions warranted,

and could regulate consumer protection standards in the absence of federal action. This would allow states to serve as incubators to develop innovative regulatory solutions. Laws that are tried first at the state level and found successful often serve as the model for laws at the national level.

The national minimum standards should go beyond required disclosures and extend to substantive regulation of consumer financial products. Disclosure alone does not address the issues that gave rise to the current crisis. We need to address key issues, including affordability, suitability, and the duty of care owed by financial services providers to consumers.

While I wholeheartedly support a heightened emphasis on consumer issues, I believe the functions of consumer protection should not be separated from the role of safety and soundness. Loans that take unfair advantage of consumers adversely affect the safety and soundness of financial institutions. Regulators must consider an institution's activities holistically, to detect emerging problems and have adequate tools to respond. Too narrow a mission could lead to myopic, impractical regulations, increasing the likelihood of negative unintended consequences and threatening to undermine the safety and soundness of financial institutions. Assigning the consumer protection function to a new stand-alone agency with a limited mandate would create yet another federal bureaucracy, at a time when I believe we need to be streamlining and avoiding counter-productive regulatory turf wars.

I recognize that the Federal Reserve Board may have been slow to take up consumer protection responsibilities placed on it by Congress. However, I believe that the current crisis has demonstrated to the Fed the importance of consumer protection to the health of our financial institutions and the economy as a whole.

- THE FEDERAL RESERVE BOARD SHOULD BE THE SYSTEMIC REGULATOR

The Panel's report correctly identifies the need for a federal systemic risk regulator, and I concur with proposals, such as those by the Group of Thirty, that this role be performed by a country's central bank.

The current crisis has demonstrated that the Federal Reserve Board, our nation's central bank, is ideally suited to harness the tools available to it to address systemic risk. The Fed has played a pivotal role in designing and implementing solutions to the current financial crisis and has gained unparalleled insight into risks presented by non-banking as well as banking institutions. However, the Fed still has no explicit authority over many non-banking organizations that meet the definition for being "systemically significant." The Fed's function in setting monetary policy, as well as supervising banking organizations and providing discount window facilities, strategically places it at the heart of the nation's regulatory nerve center. Creating new agencies to perform these broader systemic tasks would needlessly duplicate existing functions, dilute current levels of expertise and fail to take advantage of the wealth of experience accumulated by the Fed. The Federal Reserve's mission could easily be updated to formally incorporate these tasks into a broader mandate. I am confident that result would be a healthier, more vibrant financial system.

- WE NEED TO RESTORE THE CONFIDENCE OF THE AMERICAN PUBLIC

As the Panel's report states, we need to restore a proper balance between free markets and the

regulatory framework, in order to ensure that those markets operate to protect the economy, honest market participants and the public. I look forward to working with Congress to address the issues the report identifies, so that we can restore the confidence of the American public in the financial services system.

Congressman Jeb Hensarling and former Senator John E. Sununu

Preface

As part of the Economic Emergency Stabilization Act of 2008 (Pub. L. No. 110-343), Congress required that the newly established Congressional Oversight Panel (the Panel) prepare a report "analyzing the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers, and providing recommendations for improvement, including recommendations regarding whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system, the rationale underlying such recommendation, and whether there are any gaps in existing consumer protections." Even in an environment where dozens of organizations have already offered their own perspective on the economic crisis and regulatory reform, assembling such a document in the short time the Panel has been in operation would be a daunting task. Adding to the challenge, the Panel is a diverse group which possessed a dedicated, but minimal staff well into the middle of January. As a result, much of the work drafting the Panel Report was given to individuals outside its operation.

Building consensus over such a broad range of economic questions would be difficult in any event. The timing and process for preparing this document, unfortunately, made it more so. Given the differences that remain regarding our views of the systemic weaknesses that led to the crisis, and, more important, policy recommendations for reform, we have chosen not to support the Panel Report as presented. Instead, we provide here a more concise statement of the underlying causes of the current financial crisis and a series of recommendations for regulatory modernization. While there are several points in the Panel Report with which we agree, we also provide a summary of several areas where our disagreement led us to oppose the final product.

This statement is organized into several sections:

1. Introduction
2. Observations on Current State of Financial Regulation
3. Underlying Causes of the Credit Crisis
4. Recommendations for Financial Service Regulatory Modernization and Reform
5. Differences with Congressional Oversight Panel Recommendations

In preparing this summary, we drew heavily from several sources, which presented a range of views, but in which we also shared many common themes and recommendations. These include the Group of 30's *Financial Reform: A Framework for Financial Stability*, the Committee on Capital Markets Regulation's *Recommendations for Reorganizing the U.S. Financial Regulatory Structure*, the GAO's *A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, and the Department of the Treasury's *Blueprint for a Modernized*

Financial Regulatory Structure. Others playing an influential role in helping frame the often complicated policy questions engendered by this work include the scholars at the American Enterprise Institute (AEI), particularly Peter Wallison and Alex Pollock, as well as those at George Mason University's Mercatus Center, including Professor Todd Zywicki, Houman B. Shadab, and Satya Thallam.

If one theme emerged among others in these differing perspectives on the challenges ahead, it is that our pursuit should not be simply to identify new rules or areas in which to regulate, but to build a structure and system that is modern and appropriate to the institutions and technologies being used every day. A well-designed system should enhance market discipline, minimize risks to taxpayers, and avoid the pitfalls of unintended consequences. We hope our recommendations are true to these objectives.

Introduction

Since the collapse and rescue of Bear Stearns in March 2008, legislators, regulators, and financial market participants have found themselves enmeshed in a discussion of whether the financial system needs to be saved, and, if so, how best to save it. In October 2008, Congress passed the Emergency Economic Stabilization Act (EESA), which made available $700 billion for the purpose of purchasing mortgage-backed securities from financial institutions in hope of stabilizing the financial system. Shortly after Congress voted to make these funds available, the Treasury Department changed course and instead decided to purchase capital in the nation's financial institutions to free up credit markets.

Recent events—including additional losses by the nation's financial institutions, new Treasury programs to support two of the country's largest financial firms, and reports that the sums spent thus far on recapitalizing financial institutions have had only modest impact—demonstrate that while identifying problems in a marketplace might be easy, the task of isolating those problems, diagnosing their cause, and discerning how best to address them remains challenging. The conversation over how best to revive the financial system continues, and despite its urgency, it is essential that the participants in that conversation not rush to act in pursuit of a plan that fails to solve the problems we face, or makes them worse.

Beyond the pressing challenges to stabilize our economic system, however, is the broader question of how best to oversee our financial system. If reorganization is to be done responsibly, it will demand an extraordinary amount of study, research, thought, and discussion, beginning with a careful, unbiased consideration of what exactly led to the crisis that now threatens our financial system. The observations and recommendations contained in these views should therefore be viewed as a preliminary contribution to the debate, not the final word. If not for reasons of modesty, then for reasons of prudence and responsibility, readers should be cautioned that this represents the opening round of a longer conversation regarding the future of our financial system.

While the rapid escalation of the credit crisis last fall forced Congress to forgo a more deliberative process in considering policy options to respond, it is widely acknowledged now by both proponents and opponents of congressional action that properly addressing this crisis will involve a more carefully crafted response than the broadly defined powers given to Treasury under the $700 billion EESA. The stakes are no less important in regulating our financial system, for the consequences of mistakes made in rushing to fix a problem not fully understood will sow the seeds

of even greater problems in the future.

As a precursor for constructive reform, policy makers must first avoid a reflexive urge to simply write new rules. In the wake of the largest financial crisis since the Great Depression, some have called immediately to "reregulate" the financial system to prevent calamities like this from occurring again. Those that believe that regulation is the only answer, however, ignore the significant ways in which government intervention magnified our existing problems. In fact, there are few, if any, segments of the economy in which government regulates, intervenes, and legislates as heavily as it does in the financial and housing sectors. Before embracing more government regulation as the only answer, such advocates should consider the many ways in which government regulation itself can be part of the problem. The history of financial regulation is replete with such examples as either regulators or regulation have simply failed or made matters worse.

In fact, the hallmark of past efforts to regulate the financial system has been that government regulation frequently fails. History has also repeatedly shown us that adding rigid new government regulations in the midst of a crisis to solve existing problems may be like the old military adage of armies being prepared to fight the last war. For example:

1. For decades, banking regulators tried to fix deposit prices nationally through "Regulation Q," which effectively denied savers significant amounts of interest and, in turn, imperiled thrifts and banks as deposits fled when interest rates were high. As with all government regulation, Reg Q was grounded in the belief that government mandates could manage market forces and keep banks safer.
2. Twenty years ago, in response to the failure of 1,600 commercial banks in the savings and loan crisis, the federal government enacted the Federal Deposit Insurance Corporation Improvement Act of 1991 (Pub..L. No. 102-242) (FDICIA), which significantly tightened bank and S&L regulation in an attempt to generate stability. However, the tougher restrictions of FDICIA did not fix the problem, and the savings and loan crisis ended up costing American taxpayers over $120 billion.[114]
3. More recently, state and federal legislation mandated the use of credit ratings from a few rating agencies, which effectively transformed these agencies into a government-sponsored cartel. What began as an impulse to bring safety and objectivity to the regulation of broker-dealers ended by creating a concentrated point of failure, jeopardizing the entire financial system.
4. Finally, there is the example of the Federal Reserve's effort to use monetary policy to avoid the recessionary effects of the tech bubble's bursting, only to find that in doing so, it had helped create the housing bubble.

In addition to its demonstrated failure in preventing financial collapse, regulation imposes significant costs on the financial system in several ways. For example, rather than increasing stability and enhancing safety, regulation can invite chaos and encourage otherwise irrational risk taking among market participants who falsely believe that government will act as a guardian angel to protect them. Market participants thus underprice risk because they conjecture government has managed the risks that market participants would otherwise have had to assess. However, in reality,

[114] Timothy Curry and Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, FDIC Banking Review (December 2000) (online at www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf).

any government—from our current one to the most heavy-handed of all totalitarian central planners—can never completely regulate a market given its resource constraints and the ingenuity of individual entrepreneurs with a proper profit motive.

Regulation can also reduce competition because its costs are more easily borne by large companies than by small ones. Large companies also have the ability to influence regulators to adopt regulations that favor their operations over those of smaller competitors. This is particularly true when regulations add costs that smaller companies cannot bear. Take, for example, the continuing decline in the number of community banks, the locally owned and operated institutions at the heart of many small towns and cities across the county. In 2004, the Federal Deposit Insurance Corporation (FDIC) released a report on the future of banking that found that although community banks still make up a majority of the banking industry, the number of community banks had been cut almost in half since 1985. The report also found that their deposit share has also declined significantly in that time frame as large banks extended their geographic reach.[115] Regulation also may keep low cost producers or international competitors out of regulated markets.

Regulation can also harm consumers in the form of higher costs, less innovation, and fewer choices. Regulatory costs are passed along to consumers through higher prices for services or products. For an example, one need only look at their monthly telephone bill to see firsthand how the cost of various government regulations imposed on phone services are directly passed onto consumers in the form of new fees. Since the application of regulations over a population is generally universal but the direct benefits are often only individually realized, many regulations end up imposing costs on all consumers for the benefit of a limited few. Additionally, the associated cost of some regulations end up exceeding their value by adding costs to the process of developing new products or new services. There are countless examples of this phenomenon in the insurance industry, where it can take years to achieve the regulatory approval needed to roll out a new product offering or, in some bewildering cases, to enact rate reductions for the benefit of consumers if the reduction is approved at all.[116]

Instead of creating new regulatory hurdles, a superior approach to better protect consumers and preserve wealth-creating opportunities is to enhance and reinforce wise regulation while bolstering private sector market discipline. This belief was well articulated in March 2000, when Gary Gensler, then Under Secretary for Domestic Finance in President Clinton's Treasury Department and currently President Obama's nominee to chair the Commodity Futures Trading Commission (CFTC), testified before the House Financial Services Committee regarding systemic risk in our capital markets. Over the course of his remarks, Gensler explained that instead of advocating for new or increased regulations, the approach supported by Treasury emphasized the formative role of the private sector in protecting market participants:

> The public sector has three roles.... Promoting market discipline means crafting government policy so that creditors do not rely on governmental intervention to

[115] Tim Critchfield with Tyler Davis, Lee Davison, Heather Gratton, George Hanc, and Katherine Samolyk, *Community Banks: Their Recent Past, Current Performance, and Future Prospects* (2004) (online at www.fdic.gov/bank/analytical/future/fob_03.pdf) (hereinafter "FDIC Future of Banking Study").

[116] John Kennedy, *Gov. Crist, State Regulators Reject State Farm's 7 Percent Rate Reduction*, Chicago Tribune (July 31, 2007) (online at www.chicagotribune.com/business/sfl-0731statefarm,0,3467689.story).

safeguard them against loss.

> Transparency is the necessary corollary to market discipline. The government cannot impose market discipline, but it can enhance its effectiveness by promoting transparency. Transparency lessens uncertainty and thereby promotes market stability.
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> Promoting competition in financial markets lessens systemic risk. The task of public policy must be to ensure the stability and integrity of the market system. In any sector of the financial market, the dominance of one or two firms can lessen competition and the efficiency of the market pricing mechanism. In addition, the entry of a subsidized financial institution into a market may motivate other firms to take on greater risks and weaken their operating results.[117]

Under Secretary Gensler had the right idea then, and his words should help provide the framework for the structural changes to our regulatory regime that we are now considering.

Observations on Current State of Financial Regulation

The United States has the most robust, accessible, and sound financial structure of any country in the world. That structure has provided unparalleled opportunities for millions, from seasoned market participants to casual investors to hardworking teachers and nurses hoping to live out the American dream. The success of our structure has been based on market discipline coupled with an appropriate level of regulation that fosters competition, transparency, and accountability.

Yet recently, this approach has been attacked by a small but vocal chorus claiming that two decades of financial deregulation has initiated the crisis that our financial system is now facing. These advocates of expanded government power contend that for years, government has been hard at work repealing all aspects of regulation in our financial sector. However, while such rhetoric might elicit some populist appeal, such claims do not bear scrutiny because the facts simply do not exist to support them.

One frequent argument heard from many critics is that the Gramm-Leach-Bliley Act (P.L. 106-102), which repealed the Depression-era Glass-Steagall Act's separation of investment and commercial banking, was somehow responsible for the current credit crisis. To the contrary, a wide variety of experts across the political spectrum have dismissed that claim as "a handy scapegoat"[118] at best. When asked in October 2008 if Gramm-Leach-Bliley was a mistake, Alice M. Rivlin, the former director of both the Congressional Budget Office and the Office of Management and Budget, testified: "I don't think so, I don't think we can go back to a world in which we separate different kinds of financial services and say these lines cannot be crossed. That wasn't working very well.... We can't go back to those days, we have got to figure out how to go forward."[119] Even former President Bill Clinton remarked in a 2008 interview that "I don't see that signing that bill had

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[117] House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of Gary Gensler, *Securities and Government Sponsored Enterprises*, 106th Cong. (Mar. 22, 2000) (online at financialservices.house.gov/banking/32200gen.htm).

[118] David Leonhardt, *Washington's Invisible Hand*, New York Times (Sept. 26, 2008).

[119] House Financial Services Committee, Oral Remarks of Alice Rivlin, *The Future of Financial Services Regulation*, 110th Cong. (Oct. 21, 2008) (online at financialservices.house.gov/hearing110/hr102108.shtml).

anything to do with the current crisis."[120] If anything, Gramm-Leach-Bliley has played a significant role in attenuating the severity of this crisis by allowing commercial banks to merge with floundering investment banks—like JPMorgan Chase and Bear Stearns, Bank of America and Merrill Lynch, and Goldman Sachs and Morgan Stanley—actions that would have been explicitly prohibited had the Glass-Steagall Act still been in effect.

Although the advocates for expanded government power would have you believe otherwise, a careful examination of the historical record points toward the conclusion that regulation of the financial services sector has at least held constant if not substantially *increased* in recent years. One need only think about the sprawling regulatory mandate that the Sarbanes-Oxley Act (P.L. 107-204) imposed upon our financial system. Intended to toughen financial reporting requirements in the wake of the Enron scandal, Sarbanes-Oxley has created many needed reforms but its burden has also resulted in many companies taking their business—and their money—overseas. The result has been a flow of capital away from the U.S., capital which could have helped to shore-up American banks. In addition to Sarbanes-Oxley, over the last twenty years the federal government has implemented a wide array of new regulations on banks, mortgage lenders, and other financial services companies. These new regulations include:

1. The Federal Deposit Insurance Corporation Improvement Act of 1991 (P.L. 102-242), which was designed to improve bank supervision, examinations, and capital requirements.
2. The Home Ownership and Equity Protection Act (HOEPA) of 1994 (P.L. 103-325), which mandates enhanced disclosures by lenders who make certain high-cost refinancing loans to borrowers.
3. The 1989 and 2002 expansions of the mandated data furnished by lenders under the Home Mortgage Disclosure Act (HMDA).
4. The 2001 Bank Secrecy Act amendments made by the USA PATRIOT Act (P.L. 107-56), which enhanced anti-terrorist and money laundering record-keeping requirements for banks.
5. The Fair and Accurate Credit Transactions Act of 2003 (P.L. 108-159), which created new information sharing, indentify theft protection, and consumer disclosure mandates.
6. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (P.L. 109-8), which required lenders to provide new disclosures regarding credit offers and interest rates.
7. Various other Truth in Lending Act (TILA)/Regulation Z regulations and other federal banking agency guidance regarding lending, offers of credit, and consumer protections.

In fact, instead of wholesale deregulation, the case can be made that government has made concerted efforts to strengthen the very regulations that helped set the stage for the current financial crisis. To take one obvious example, there has been a strengthening of the Community Reinvestment Act, which has encouraged banks to make mortgage loans to borrowers who previously would have been rejected as non-creditworthy. Also, the Department of Housing and Urban Development's (HUD) affordable housing mandates for the government-sponsored enterprises (GSEs) were steadily increased from the 1990s through 2008, adding new targets and rules that compelled Fannie and Freddie to take certain loan purchasing actions to stay in compliance. Additionally, U.S. bank regulators are moving to quickly implement new capital

[120] *Bill v. Barack on Banks*, Wall Street Journal (Oct. 1, 2008) (online at online.wsj.com/article/SB122282635048992995.html).

requirements through the Basel II capital accord, which was less than two years old when plans for its adoption were announced on September 30, 2005. These untested rules will replace the Basel I rules that generally assigned lower capital charges for housing assets, which tended to increase the leveraging of housing-related assets, making our financial system less stable.[121]

Furthermore, proponents of the "regulation is the cure" argument must bear in mind that the most egregious financial failures have occurred not in the unregulated financial markets of hedge funds and over-the-counter derivatives, but in the highly regulated world of commercial and investment banking, where regulation has been the most burdensome. The former U.S. investment banks—which bought the so-called toxic assets that have been identified as one of the root causes of the financial crisis—were regulated by the Securities and Exchange Commission (SEC). Yet that supervision was insufficient to prevent the collapse of Bear Stearns or Lehman Brothers, two of this nation's largest investment banks, or the charter transformation of two other large investment banks, Goldman Sachs and Morgan Stanley, into bank holding companies. The credit rating agencies that blessed these products with AAA ratings were also regulated by the SEC, yet that supervision was not enough to prevent the inaccurate evaluations and gross errors in judgment of those agencies.

This nation's highly regulated commercial banks, subject to regulation by several agencies similarly snapped up large quantities of these assets, all while supposedly under the oversight and supervision of their regulators. Yet the results of this country's heavy regulation of commercial banks have also been abysmal. Wachovia, formerly the nation's fourth largest bank, was regulated by the Comptroller of the Currency (OCC). Countrywide Financial was a national bank under OCC supervision until mid-2007, and then it became a federal thrift regulated by the Office of Thrift Supervision (OTS). Washington Mutual, IndyMac and Downey Savings and Loan Association were all also federal thrifts regulated by the OTS. All five were well regulated. And the housing market collapse caused all five to fail.[122]

By contrast, many of the less stringently regulated actors in the financial system, such as hedge funds and other private pools of capital, and less stringently regulated products, such as derivatives and swaps traded over the counter, seem to have weathered the crisis better than their highly regulated counterparts. While investors in some of those products have lost money, and some of the companies engaged in those lines of business have closed their doors, these failures did not produce massive systemic risk concerns that required federal intervention placing taxpayer dollars at risk.

These observations lead to the clear point that heavy regulation, despite the outsized claims made for its effectiveness in avoiding crisis, will not solve our problems. As financial historian Bernard Shull stated in a 1993 paper on the matter:

> Comprehensive banking reform, traditionally including augmented and improved supervision, has typically evoked a transcendent, and in retrospect, unwarranted

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[121] Risk-based Capital Standards: Advanced Capital Adequacy Framework – Basel II, 72 Fed. Reg. 69,288 (Dec. 7, 2007) (to be codified at 12 C.F.R. pts. 3, 208, 225, 325, 559, 560, 563, 567) (online at www.setonresourcecenter.com/register/2007/Dec/07/69288A.pdf).

[122] Binyamin Appelbaum and Ellen Nakashima, *Banking Regulator Played Advocate Over Enforcer*, Washington Post (Nov. 23, 2008.) (online at www.washingtonpost.com/wp-dyn/content/article/2008/11/22/AR2008112202213_pf.html).

> optimism. The Comptroller of the Currency announced in 1914 that, with the new Federal Reserve Act, "financial and commercial crises or panics … Seem to be mathematically impossible." Seventy-five years later, confronting the S&L disaster with yet another comprehensive reform … The Secretary of the Treasury proclaimed "two watchwords guided us as we undertook to solve this problem: Never Again."[123]

More than fifteen years after Shull's paper, many stand ready to march down the same well-worn path, clinging to the belief that heavy-handed regulation holds the answer. Those claims should be rejected. There is a better and more effective path to choose.

A Brief History of the Subprime Crisis

To some observers, the turmoil in the U.S. financial markets, caused by severe dislocations in the country's housing markets, has heralded the end of the free-market system. But with all due respect to the critics of capitalism, the economic crisis in which the country now finds itself reflects not the failure of the free-market system, but more so the result of decades of misguided government policies that interfered with the functioning of that system. While recent events demonstrate a need for regulatory reform, modernization, and improvement, the larger lesson is that a number of well-meaning but clearly misguided government policies distorted America's housing markets, which in turn produced grave consequences for the financial system and the underlying economy.

In a rush to be seen as doing "something" in response, the advocates of expanded government power have brought forward a range of old proposals to regulate, reregulate, and overregulate any and every aspect of our economy. We believe a more practical approach would be to identify and correct the government policies that inflated the housing bubble underlying this crisis and then decide what change is necessary. Thus, the essential debate is not between deregulation and re-regulation, but instead between *wise* regulation and *counterproductive* regulation. Wise regulation helps make markets more competitive and transparent, empowers consumers with effective disclosure to make rational decisions, effectively polices markets for force and fraud, and reduces systemic risk. Counterproductive regulation hampers competitive markets, creates moral hazard, stifles innovation, and diminishes the role of personal responsibility in our economy. It is also procyclical , passes on greater costs than benefits to consumers, and needlessly restricts personal freedom.

Those who simply advocate for reregulation because they claim that the free markets have failed ignore the various ways that government itself helped set the stage for the current financial crisis. The housing sector—where the difficulties confronting our markets started—is not a deregulated, free-market in any sense of the word. This country's housing market is overloaded with substantial government components, including the regulatory roles of large government agencies; implicit and explicit government guarantees supporting the underwriting, issuance, and securitization of mortgages; and a cluster of mandates aimed at achieving universal home ownership. Indeed, the crisis this country finds itself facing does not stem from deregulation (since little has taken place over the last couple of decades) or even the mistakes of participants in the free market (although

[123] Bernard Shull, *The Limits of Prudential Supervision: Economic Problems, Institutional Failure and Competence* (1993) (online at www.levy.org/download.aspx?file=wp88.pdf&pubid=378).

many harmful mistakes were committed), but instead from the myriad ways in which government initiatives interfered with the functioning of private markets.

Our observations have led us to conclude that there are at least five key factors that led to the current crisis:

1. A highly accommodative monetary policy that lowered interest rates dramatically, kept them low, and inflated the housing bubble.
2. Broad federal policies designed to expand home ownership in an "off-budget" fashion, which encouraged lending to those who could not afford home ownership.
3. The moral hazard inherent in Fannie Mae and Freddie Mac, the two failed GSEs, which exploited their congressionally granted duopoly status to benefit from privatized profits earned against socialized risks taken.
4. An anticompetitive government sanctioned credit rating oligopoly that misled investors and failed in its responsibility to provide accurate, transparent assessments of risk.
5. Failures throughout the mortgage securitization process that resulted in the abandonment of sound underwriting practices.

Monetary Policy. The Federal Reserve set the stage for a wave of mortgage borrowing by keeping credit conditions too loose for too long earlier this decade. In response to the bursting of the high-tech bubble in 2000, the Federal Reserve began lowering interest rates in early 2001 to cushion the economic fallout. These highly accommodative policies were maintained in response to the 2001 recession and the economic shock of the 9-11 terrorist attacks. The target for the federal funds rate—the benchmark interbank lending rate in the U.S.—was lowered to just 1 percent by mid-2003, and maintained at that level until mid-2004.[124] The real funds rate—which is the difference between the funds rate set by the Federal Reserve and expected inflation—demonstrates just how aggressively the Federal Reserve was in conducting monetary policy during this period. The real funds rate dropped from 4 percent in late 2000 to -1.5 percent by early 2003.[125]

The Federal Reserve's decision to cushion the economic blow from the dramatic collapse in equity prices unleashed a wave of cheap credit on a housing market that was already experiencing a boom cycle. By mid-2003, the interest rate on a conventional thirty-year mortgage dipped to an all-time low of just 5.25 percent, fueling demand in the housing market thanks to mortgage credit that had become cheap and plentiful in light of the Federal Reserve's rate cuts.[126] As a result of demand and cheap credit, new home construction rose to a twenty-five-year high in late 2003, and remained at historic levels for two years.[127]

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[124] Federal Reserve Board, *Open Market Operations* (online at www.federalreserve.gov/fomc/fundsrate.htm) (accessed Jan. 26, 2009).

[125] Mark Zandi, *Financial Shock: A 360º Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis* (2009).

[126] Federal Reserve Bank of St. Louis, *Economic Research* (online at research.stlouisfed.org/fred2/series/MORTG/).

[127] *Remarks of John B. Taylor at the Symposium of Housing, Housing Finance, and Monetary Policy sponsored by the Federal Reserve Bank of Kansas City in Jackson Hole, Wyoming* (Sept. 2007) (online at www.kc.frb.org/PUBLICAT/SYMPOS/2007/PDF/Taylor_0415.pdf).

It has been widely reported that over the last fifty years, there has not been a single year in which the national average home value had fallen despite some regional declines and various economic troubles and recessions. The allure of this statistic was so appealing that even former Federal Reserve Chairman Alan Greenspan and current Chairman Ben Bernanke at various points attested to it in defense of our housing markets. In fact, a 2004 report by top economists from Fannie Mae, Freddie Mac, the National Association of Realtors, the National Association of Home Builders, and the Independent Community Bankers of America entitled *America's Home Forecast: The Next Decade for Housing and Mortgage Finance* even concluded that "there is little possibility of a widespread national decline since there is no national housing market."[128] This widely held belief augmented Federal Reserve monetary policy and further inflated the housing bubble.

Even with the brisk pace of home construction, demand still outstripped supply, pushing home prices even higher. Between 1995 and 2002, in the midst of the housing boom, home prices appreciated between 2 percent and 5 percent a year. By 2004 and 2005, at the height of the bubble, home prices were appreciating at nearly 15 percent per year. Between 1997 and 2006, real home prices for the U.S. as a whole increased 85 percent. Another measure of the unsustainable inflation that took place in housing prices is the relationship between house prices and rents. Over the past twenty-five years, the price-to-rent ratio was roughly 16.5. In 2003, at the start of the bubble, the price-to-rent ratio was 18.5. It then quickly grew to an all-time peak of 25 by the end of 2005.[129]

The bubble grew as cheap credit and sharply increasing home prices fueled the frenzy of first-time homeowners eager to buy into a market before prices got out of reach. It also encouraged current homeowners to purchase bigger homes or to buy additional properties for investment purposes. Federal Reserve economists have estimated that the share of investment real estate purchases jumped to roughly 17 percent in 2005 and 2006 at the height of the housing boom, up from just more than 6 percent a decade earlier.[130]

These double digit increases in housing prices not only stimulated demand among home buyers who wanted to get into the housing market before they were priced out or were eager to invest on rising home prices, they also created an environment in which lenders, securitizers, and investors believed that it was impossible to make a bad loan. The consequences should have been foreseeable. Borrowers bought bigger, more expensive homes, betting that perpetually rising housing prices would allow them to refinance their mortgages at a later date while benefiting from ongoing appreciation in housing values. Lenders assumed that even if buyers defaulted, rising house prices would allow them to sell the home for more than the amount owed by the borrower.

Economists have consistently identified the Federal Reserve's accommodative monetary policy as one cause of the current financial crisis. For example, John B. Taylor, a professor of economics at

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[128] David Leonhardt and Vikas Bajaj, *Drop Foreseen in Median Price of U.S. Homes*, New York Times (Aug. 26, 2007) (online at www.nytimes.com/2007/08/26/business/26housing.html?ei=5090&en=9bd44f2f8b0ef4f4&ex=1345780800&partner=rssuserland&emc=rss&pagewanted=all).

[129] Zandi, *supra* note 125; Robert J. Shiller, *The Subprime Solution: How Today's Global Financial Crisis Happened, and What to Do About It* (2008).

[130] Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *The 2006 HMDA Data*, Federal Reserve Bulletin (Dec. 2007).

Stanford and the creator of the "Taylor rule" guideline for monetary policy, has said the Federal Reserve made a mistake by keeping interest rates so low. According to Taylor's formula, the Federal Reserve should have raised interest rates much sooner than it did given the economic conditions at the time. Taylor himself has said that "a higher funds path would have avoided much of the housing boom.… The reversal of the boom and thereby the resulting market turmoil would not have been as sharp."[131] Given the key role that the Federal Reserve's monetary policy has played in contributing to the credit crisis we now face, it must be acknowledged that those decisions had a major impact on market conditions and helped to influence how investors chose to allocate their capital in our economy.

Federal Policy to Expand Home Ownership.. For well over twenty years, federal policy has promoted lending and borrowing to expand homeownership, through incentives such as the home mortgage interest tax exclusion, the Federal Housing Administration (FHA), and discretionary spending programs such as HUD's HOME block grant program. But perhaps the most damaging initiative undertaken by the federal government was the effort to pressure private financial institutions to subsidize home ownership through the Community Reinvestment Act (CRA). Undertaken with the best of intentions—expanding home ownership among poor and underserved communities—the unintended consequences of the CRA clearly demonstrate that government's attempts to manipulate market behavior to achieve social goals often lead to harmful results.

Enacted in 1977, the CRA encouraged banks to extend credit to "underserved" populations by requiring that banks insured by the federal government "help meet the credit needs of its entire community." To ensure that banks are meeting this mandate, each federally insured bank is periodically examined by its federal regulator. As a result of its enactment, bank lending to low- and moderate-income families has increased by 80 percent.[132]

In 1997, Wall Street firms, the GSEs, and the CRA converged in a landmark event: the first securitization of CRA loans, a $384-million offering guaranteed by Freddie Mac.[133] Over the next 10 months, Bear Stearns issued $1.9 billion of CRA mortgages, backed by Fannie or Freddie, and between 2000 and 2002 this business accelerated in dramatic fashion as Fannie Mae issued $20 billion in securities backed by CRA mortgages.[134] By encouraging lenders and underwriters to relax their traditional underwriting practices, the CRA, investment firms and the GSEs saddled American taxpayers with the consequences of mortgages that borrowers cannot repay.

Equally problematic are reports that some of these CRA-inspired loans are mortgages that borrowers can repay, but choose not to, given that the property that secures these loans is now worth less than the amount outstanding. Whether borrowers cannot or will not repay, the irony is that these lower-income home buyers—those who were supposed to benefit from the government's actions—are now defaulting at a rate three times that of other borrowers. With these defaults, the damage to

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[131] Taylor, *supra* note 127.

[132] U.S. Department of the Treasury, *The Community Reinvestment Act after Financial Modernization: A Baseline Report* (Apr. 2000).

[133] First Union Capital Markets Corp., *Bear, Stearns & Co. Price Securities Offering Backed By Affordable Mortgages Unique Transaction to Benefit Underserved Housing Market* (Oct. 20, 1997).

[134] *Fannie Mae Increase CRA Options*, ABA Banking Journal (Nov. 1, 2000).

homeowners, neighborhoods, state and local governments as the tax base shrinks, and now to all American taxpayers, is enormous.

In the course of this crisis, there has been some heated discussion over the role CRA loans have played in contributing to our current woes. Proponents of CRA-like mandates have maintained that only a small portion of subprime mortgage originations are related to the CRA, and those CRA loans that have been written are performing in a manner similar to other types of subprime loans. Such claims, however, miss the fundamental point that critics of the CRA have made: though they may be small in volume, CRA loan mandates remain large in precedent because they inherently required lending institutions to abandon their traditional underwriting standards in favor of more subjective models to meet their government mandated CRA obligations.

For example, in April of 1993, the Boston Federal Reserve Bank, under the leadership of future Freddie Mac Chairman Dick Syron, published an influential best practices guide called *Closing the Gap: A Guide To Equal Opportunity Lending*. The guide made several recommendations to lending institutions on various ways they could increase their low-income lending practices. Some of these recommendations, which encouraged institutions to abandon the traditional lending and underwriting policies used to ensure the quality of loans made, included:

1. "Special care should be taken to ensure that standards are appropriate to the economic culture of urban, lower-income, and nontraditional consumers."
2. "Policies regarding applicants with no credit history or problem credit history should be reviewed. Lack of credit history should not be seen as a negative factor.… In reviewing past credit problems, lenders should be willing to consider extenuating circumstances."
3. Institutions can "work with the public sector to develop products that assist lower-income borrowers by using public money to reduce interest rates, provide down payment assistance, or otherwise reduce the cost of the mortgage."
4. "A prompt and impartial second review of all rejected applications can help ensure fairness in the lending decision and prevent the loss of business opportunities.... This process may lead to changes in the institution's underwriting policies.… In addition, loan production staff may find that their experience with minority applicants indicates that the institution's stated loan policy should be modified to incorporate some of the allowable compensating factors."[135]

Taken in isolation, the good intentions of these recommendations is plain; taken together, however, it is also clear that lenders were being urged to abandon proven safety and soundness underwriting standards in favor of new outcome-based underwriting standards. Again, the salient point is not to debate the notion of could or should more be done to make affordable loans available to underserved communities. The question is what damage is done to the overall stability of an institution when it alters its lending guidelines to comply with a government mandate to advance a social policy.

Similarly, banks were urged by other private sector parties to ignore traditional lending guidelines,

[135] Boston Federal Reserve, *Closing the Gap: A Guide to Equal Opportunity Lending* (Apr. 1993) (online at www.bos.frb.org/commdev/commaff/closingt.pdf).

this time in the pursuit of greater and faster profit. In May of 1998, Bear Stearns published an article with guidance on why and how lenders should package CRA loans into mortgage backed securities.[136] That document advised lenders that: "Traditionally rating agencies view LTV [loan-to-value ratios] as the single most important determinant of default. It is most important at the time of origination and less so after the third year." Bear Stearns also encouraged lower lending standards by arguing that when "explaining the credit quality of a portfolio to a rating agency or GSE, it is essential to go beyond credit scores," and that "the use of default models traditionally used for conforming loans have to be adjusted for CRA affordable loans." While such advice might have been important to maximizing profitability, Bear Stearns' guidance is yet one more example of how the conflict between a social policy mandate like the CRA and the fiscal requirements of basic safety and soundness operations led to a dangerous diminution in lenders' traditional underwriting standards.

The GSEs. Standing at the center of the American system of mortgage finance are the two now-failed government-chartered behemoths created to expand homeownership opportunities: the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Market participants have long understood that this government created duopoly was implicitly, though not explicitly, backed by the federal government. This "implied guarantee" flowed from several factors, including the very existence of a government charter that effectively sanctioned this duopoly, access to a Treasury line of credit, and exemption from payment of state and local taxes. Although Fannie and Freddie were nominally designed to be competitors, in practice this implied guarantee allowed the two largely to work in unison as a cartel to set and maintain prices in the market.

The dangers inherent in such an implied guarantee were twofold. First, their unique status allowed Fannie and Freddie to borrow funds in the marketplace at subsidized rates. Ostensibly, these funds would be used to purchase mortgages from lenders, fulfilling their mission to provide liquidity in the secondary mortgage markets. For over a decade, however, the GSEs continued to build enormous investment portfolios, earning profits by arbitraging the difference between their low, subsidized borrowing costs and the higher yields in their portfolio's ever riskier assets. Beginning in 1990, their investment portfolios grew tenfold, from $135 billion to $1.5 trillion,[137] allowing many of their shareholders and executives to become personally wealthy thanks to the GSEs' subsidized borrowing costs while the American taxpayer assumed most of the risk.

Second, their implied guarantee created a false sense of security and standards for the products they purchased and securitized. This perception played a major role in the proliferation of GSE-backed subprime and Alt-A securities, providing a *de facto* government seal of approval for even the riskiest loans as market participants believed these securities were appropriately priced and represented minimal risk. Their predominance in the mortgage market meant that Fannie and Freddie's business practices—credit rating, underwriting, risk modeling—were seen as the "gold standard" in the industry, despite flaws that later became apparent.

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[136] Dale Westhoff, *Packaging CRA Loans into Securities*, Mortgage Banking (May 1, 1998) (online at www.allbusiness.com/personal-finance/real-estate-mortgage-loans/677967–1.html).

[137] U.S. Department of the Treasury, *Remarks of Assistant Secretary for Financial Institutions Emil W. Henry Jr., before the Housing Policy Council of the Financial Services Roundtable* (June 26, 2006) (online at www.ustreas.gov/press/releases/js4338.htm).

For its part, Congress substantially magnified these potential risks by charging the GSEs with a mission to promote homeownership and thus inflating the supply of credit available to fund residential mortgages. The GSEs' congressional mandate and their access to cheap funding allowed the government to pressure Fannie and Freddie to expand homeownership to historically credit-risky individuals without the burden of an explicit on-budget line item at taxpayer expense, a budget goal long sought by housing advocates. For instance, in 1996, the HUD required that 42 percent of Fannie's and Freddie's mortgage financing should go to borrowers with income levels below the median for a given area.[138] HUD revised those goals again in 2004, increasing them to 56 percent of their overall mortgage purchases by 2008.[139] In addition, HUD required that 12 percent of all mortgage *purchases* by Fannie and Freddie be "special affordable" loans made to borrowers with incomes less than 60 percent of an area's median income, and ultimately increased that target to 28 percent for 2008.[140]

These "affordable housing" goals and other federal policies succeeded at increasing the homeownership rate from 64 percent in 1994 to an all-time high of 69 percent in 2005.[141] However, they did so at a great cost. To meet these increasingly large government mandates, Fannie and Freddie began to buy riskier loans and encouraged those who might not be ready to buy homes to take out mortgages. This GSE-manufactured demand boosted home prices to an artificially high level and fostered enthusiasm for the wave of exotic mortgage products that began to flood the market.

For example, in 1999, under pressure from the Clinton Administration to expand home loans among low- and moderate-income groups, Fannie Mae introduced a pilot program in fifteen major markets encouraging banks to extend mortgage credit to persons who lacked the proper credit histories to qualify for conventional loans. The risks of such a program should have been apparent to all. *The New York Times*, in a prescient comment on the program at the time, remarked: "In moving, even tentatively, into this new area of lending, Fannie Mae is taking on significantly more risk, which may not pose any difficulties during flush economic times. But the government-subsidized corporation may run into trouble in an economic downturn, prompting an economic rescue."[142]

During this period, the government also began to push Fannie and Freddie into the subprime market. In 1995, HUD authorized Fannie and Freddie to purchase subprime securities that included loans to low-income borrowers and allowed the GSEs to receive credit for those loans toward their mandatory affordable housing goals. Subprime lending, it was thought, would benefit many borrowers who did not qualify for conventional loans. Fannie and Freddie readily complied, and as a result, subprime and near-prime loans jumped from 9 percent of securitized mortgages in 2001 to 40 percent in 2006.[143]

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[138] Russell Roberts, *How Government Stoked the Mania*, Wall Street Journal (Oct. 3, 2008).

[139] *Id.*

[140] *Id.*

[141] *Id.*

[142] Steven A. Holmes¸ *Fannie Mae Eases Credit to Aid Mortgage Lending*, New York Times (Sept. 30, 1999).

[143] Roberts, *supra* note 138.

Fannie's and Freddie's heavy involvement in subprime and Alt-A mortgages increased following their accounting scandals in 2003 and 2004 in an attempt to curry favor with Congress and avoid stricter regulation. Data from these critical years before the housing crisis hit show Fannie and Freddie had a large direct and indirect role in the market for risky mortgage loans. In 2004 alone, Fannie and Freddie purchased $175 billion in subprime mortgage securities, which accounted for 44 percent of the market that year. Then, from 2005 through 2007, the two GSEs purchased approximately $1 trillion in subprime and Alt-A loans, and Fannie's acquisitions of mortgages with less than 10-percent down payments almost tripled.[144]

Without question, the purchase and securitization of such loans by Fannie and Freddie was a clear signal and incentive to all loan originators to write more subprime and Alt-A loans regardless of their quality. As a result, the market share of conventional mortgages dropped from 78.8 percent in 2003 to 50.1 percent by 2007 with a corresponding increase in subprime and Alt-A loans from 10.1 percent to 32.7 percent over the same period.[145] The message, as *The New York Times* noted, was clear: "[T]he ripple effect of Fannie's plunge into riskier lending was profound. Fannie's stamp of approval made shunned borrowers and complex loans more acceptable to other lenders, particularly small and less sophisticated banks."[146] Soon, Fannie and Freddie became the largest purchasers of the higher-rated (AAA) tranches of the subprime pools that were securitized by the market. This support was essential both to form these investment pools and market them around the world. Fannie and Freddie thus played a pivotal role in the growth and diffusion of the mortgage securities that are now crippling our financial system.

Fannie and Freddie also played a leading role in weakening the underwriting standards that had previously helped ensure that borrowers would repay their mortgages. For instance, in May 2008, Fannie and Freddie relaxed the down payment criteria on the mortgages they buy, accepting loans with down payments as low as 3 percent.[147] And in recent years both companies markedly stepped up their guarantees on Alt-A loans, which often did not require the verification of income, savings, or assets for potential borrowers. Between 2005 and the first half of 2008, Fannie guaranteed at least $230 billion worth of these risky loans, more than three times the amount it had guaranteed on all past years combined. However, these poorly underwritten loans are now increasingly turning sour amid the housing downturn, especially those concentrated in California, Florida, Nevada, and Arizona, where the housing bubble was particularly large and real estate speculation was rampant.[148]

To preserve their government-granted duopoly powers and maintain unfettered access to cheap funds, Fannie and Freddie spent enormous sums on lobbying and public relations. According to the

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[144] American Enterprise Institute, Peter Wallison and Charles Calomiris, *The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac* (Sept. 30, 2008).

[145] Joint Center for Housing Studies, *The State of the Nation's Housing* (2008) (online at www.jchs.harvard.edu/publications/markets/son2008/index.htm).

[146] Charles Duhigg, *Pressured to Take More Risk, Fannie Reached Tipping Point*, New York Times (Oct. 5, 2008).

[147] *Fannie Mae Relaxes Loan Down Payment Requirements*, Reuters News Service (May 19, 2008).

[148] James R. Hagerty, *Fannie, Freddie Share Spotlight in Mortgage Mess*, Wall Street Journal (Oct. 16, 2008).

Associated Press, they "tenaciously worked to nurture, and then protect, their financial empires by invoking the political sacred cow of homeownership and fielding an army of lobbyists, power brokers and political contributors."[149] Fannie and Freddie's lobbyists fought off legislation that might shrink their investment portfolios or erode their ties to the federal government, raising their borrowing costs. In fact, Franklin D. Raines, Fannie Mae's former chairman, once told an investor conference that "we manage our political risk with the same intensity that we manage our credit and interest rate risk."[150] Raines's statement was undoubtedly true: over the past ten years, Fannie and Freddie spent more than $174 million on lobbying.[151]

As long as times were good, the GSEs were able to point to their affordable housing goals to distract attention from the inherent risk their business model posed. But, for more than a decade, alarms have been sounded about the precarious position of the GSEs. For example, in Congress, as far back as 1998, GSE reform advocates like former Rep. Richard Baker were voicing their concerns over "the risks and potential liabilities that GSEs represent."[152] In 2000, Rep. Baker demonstrated he was far ahead of the curve when he observed that by "improving the existing regulatory structure of the housing GSEs in today's good economic climate, we can reduce future risk to the taxpayer and the economy."[153] That year, the House Financial Services Committee held no fewer than six hearings on the subject of GSE reform, with at least five more over the following two years.[154] Yet from 2000 to 2005, although at least eight major GSE reform bills were introduced in Congress, Fannie and Freddie exerted enough influence that only one, the Federal Housing Finance Reform Act of 2005, ever gained enough support to be passed by either body, but it ultimately did not become law.[155]

Others in government shared similar concerns. In 1997, the General Accountability Office cautioned in its testimony before the House Financial Services Committee that "the outstanding volume of federally assisted GSE credit is large and rapidly increasing."[156] As referenced above, then-Treasury Under Secretary Gensler testified in March 2000 that "the willingness of a GSE to purchase a mortgage has become a far more significant factor in deciding whether to originate that

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[149] Tom Raum and Jim Drinkard, *Fannie Mae, Freddie Mac Spent Millions on Lobbying,* Associated Press (July 17, 2008).

[150] Wallison and Calomiris, *supra* note 144.

[151] *Fannie Mae, Freddie Mac Spent Millions on Lobbying*, Associated Press (July 17, 2008).

[152] House Financial Services Committee, Statement of Rep. Richard Baker, *Joint Hearing on Government Sponsored Enterprises*, 105th Cong. (July 16, 1997) (online at financialservices.house.gov/banking/71697bak.htm).

[153] House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Statement of Rep. Richard Baker, *Housing GSE Regulatory Reform Hearing*, 106th Cong. (March 22, 2000) (online at financialservices.house.gov/banking/32200bak.htm).

[154] House Financial Services Committee, *Archived Hearings* (online at http://financialservices.house.gov/archive_hearings.html).

[155] H.R. 1461, 109th Cong. (2005)

[156] House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of Jim Bothwell of the Government Accountability Office, *Joint Hearing on Government Sponsored Enterprises*, 105th Cong. (July 16, 1997) (online at financialservices.house.gov/banking/71697gao.htm).

mortgage." Gensler went on to state that as the GSEs continue to grow, "issues of potential systemic risk and market competition become more relevant," and concluded that the current moment was "an ideal time to review the supervision and regulation of the GSEs."[157] In 2004, then-Federal Reserve Chairman Alan Greenspan warned in his testimony before the Senate Banking, Housing, and Urban Affairs Committee that "the current system depends on the risk managers at Fannie and Freddie to do everything just right.... But to fend off possible future systemic difficulties, which we assess as likely if GSE expansion continues unabated, preventive actions are required sooner rather than later."[158]

Outside of Congress, more red flags were flown over the obvious weaknesses of the GSE model. At another House Financial Services Committee hearing on GSEs in 2000, low-income housing advocate John Taylor of the National Community Reinvestment Coalition warned that the lack of a strong regulatory agency for Fannie and Freddie "threatens the safety and soundness of the GSEs."[159] At the same hearing, community activist Bruce Marks of the Neighborhood Assistance Corporation of America expressed his fears that without enhanced regulatory control over Fannie and Freddie, the GSEs might participate "in potentially profitable but also potentially risky investments [*sic*] schemes [that] pose potential risks for the housing and banking industry and for the economy in general."[160]

Unfortunately, despite all the evidence of systemic risk and repeated efforts to consolidate, strengthen, and increase regulatory oversight of Fannie and Freddie, calls for reform mostly fell on deaf ears. One reason why reform efforts failed was that the GSEs and their ardent defenders in Congress have spent the better part of the last decade first ignoring, then rejecting, then attempting to contradict the mounting evidence that the whole system was in danger. In 2001, Fannie Mae itself attempted to dispel the need for any change, declaring before Congress that "we operate successfully under the most rigorous of safety and soundness regimes; we are subject to a high level of market discipline and provide the marketplace with world-class disclosures."[161] Freddie Mac, for its part, used the same hearing to proclaim that their "superior risk management capabilities, strong capital position and state-of-the-art information disclosure make Freddie Mac unquestionably a safe and sound financial institution."[162]

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[157] Gensler, *supra* note 117.

[158] Senate Committee on Banking, Housing, and Urban Affairs, Testimony of Alan Greenspan, *Proposals for Improving the Regulation of the Housing Government Sponsored Enterprises*, 108th Cong. (Feb. 24, 2004) (online at www.access.gpo.gov/congress/senate/pdf/108hrg/21980.pdf).

[159] House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of John Taylor, *Hearing on Improving Regulation of Housing GSEs*, 106th Cong. (June 15, 2000) (online at financialservices.house.gov/banking/61500tay.htm).

[160] House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of Bruce Marks, *Hearing on Improving Regulation of Housing GSEs*, 106th Cong. (June 21, 2000) (online at financialservices.house.gov/banking/62100mar.htm).

[161] House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of J. Timothy Howard of Fannie Mae, *Hearing on Reforming Fannie Mae and Freddie Mac*, 107th Cong. (July 11, 2001) (online at financialservices.house.gov/media/pdf/071101th.pdf).

[162] House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Government

After their credibility eroded from their accounting scandals, Fannie and Freddie increasingly relied on elected officials to fight attempts at reform. In 2003, Rep. Barney Frank famously remarked at a hearing on a pending GSE reform bill: "I believe there has been more alarm raised about potential [GSE] un-safety and unsoundness than, in fact, exists.... I do not want the same kind of focus on safety and soundness that we have in OCC and OTS. I want to roll the dice a little bit more in this situation towards subsidized housing."[163] In 2004, Senator Chris Dodd called Fannie and Freddie "one of the great success stories of all time,"[164] while in 2005 Senator Chuck Schumer confessed that perhaps "Fannie and Freddie need some changes, but I don't think they need dramatic restructuring in terms of their mission."[165] The scope of this head-in-the-sand mentality was perhaps most completely embodied by Rep. Maxine Waters who, in 2002, categorically rejected the need for any GSE reform bill, proclaiming at a House Financial Services Committee hearing on the matter "If it is not broken, why fix it?"[166]

Although it is fair to say that no one ought to be blamed for lacking the ability to predict the future, the fact remains that for more than a decade there were clear, discernable, and announced warnings that Fannie and Freddie were growing too big and that if left unchecked would eventually collapse beneath their own weight. Too many public policy makers failed to heed those warnings, or knowingly disregarded them, and as a result taxpayers have now been left to pick up the pieces by taking on hundreds of billions of dollars worth of risk. Ironically, when the housing bubble finally burst, the resulting wave of foreclosures stemming from loans the GSEs forced into the market will likely end up reducing homeownership rates across the country, a direct contradiction to the stated purpose of Fannie and Freddie that their supporters for so long sought to advance.

Credit Rating Agencies. In order to sell subprime securities to investors, those securities first had to be rated by the credit rating agencies. Like so many other players, the credit rating agencies were caught up in the pursuit of fees generated from the real estate boom. This overwhelming desire to maximize their profits from the housing bubble is perhaps best captured by an e-mail message from a Standard & Poor's official who wrote that "We rate every deal. It could be structured by cows and we would rate it."[167] To perform their work, these agencies made extensive use of sophisticated modeling in an attempt to predict risk and the likelihood of default on loans. However, much like everyone else, the credit rating agencies falsely assumed that housing prices would never go down nationwide, which meant that their elaborate mathematical models were defective from the start. When mortgage defaults accelerated and home prices began to plummet, securities based on those

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Sponsored Enterprises, Testimony of Mitchell Delk of Freddie Mac, *Hearing on Reforming Fannie Mae and Freddie Mac*, 107th Cong. (July 11, 2001) (online at financialservices.house.gov/media/pdf/071101md.pdf).

[163] House Financial Services Committee, Oral remarks of Rep. Barney Frank, *Hearing on H.R. 2575, The Secondary Mortgage Market Enterprises Regulatory Improvement Act*, 108th Cong. (Sept. 25, 2003) (online at financialservices.house.gov/media/pdf/108-54.pdf).

[164] *What They Said About Fan and Fred*, Wall Street Journal (Oct. 2, 2008).

[165] *Id.*

[166] House Financial Services Committee, Statement of Rep. Maxine Waters, *Hearing on Housing Government Sponsored Enterprises*, 107th Cong. (July 16, 2002) (online at financialservices.house.gov/media/pdf/071602wa.pdf).

[167] House Committee on Oversight and Government Reform, *Hearing on Credit Rating Agencies and the Financial Crisis*, 110th Cong. (Oct. 22, 2008) (online at oversight.house.gov/documents/20081023162631.pdf).

loans that were once highly rated were downgraded to junk causing a wave of financial turmoil for scores of market participants at every level.

But the failure of the credit rating agencies would not have generated the disastrous consequences that it did had that failure not been compounded by further misguided government policies, which had effectively allowed the credit rating agencies to operate as a cartel. For decades, federal financial regulators have required that regulated entities heed the ratings of a select few rating agencies. For example, since the 1930s regulators have not allowed banks to invest in bonds that are below "investment grade," as determined by the select few rating agencies as recognized by the government. Although the goal of having safe bonds in the portfolios of banks may be a worthy one, bank regulators essentially delegated a major portion of their safety assessments to the opinions of these rating agencies.

This delegation of authority by bank regulators was further compounded in 1975, when the SEC also delegated its safety judgments regarding broker-dealers to the credit rating agencies. As an attempted safeguard against unqualified agencies from participating in the process, the SEC created a new Nationally Recognized Statistical Rating Organization (NRSRO) designation for qualified entities, and immediately grandfathered the three large rating agencies into this category. Following the SEC, other financial regulators soon adopted the NRSRO category for their delegations, assuming this government stamp of approval would ensure the continued quality of the ratings produced by those agencies.

Over the next 25 years, the SEC allowed only four more rating firms to achieve the NRSRO designation, but mergers among the NRSROs eligible to issue ratings recognized by the regulators shrunk the number of NRSROs back to three by year-end 2000. In 2006, Congress passed legislation (Pub. L. No. 109-291) to address part of this situation which required that the SEC cease being a barrier to entry for legitimate rating agencies, and gave it limited regulatory powers over the NRSROs. Although the SEC has designated six additional NRSROs since 2000,[168] competition and transparency in the ratings agency system remains inadequate. The SEC has never developed criteria for the designation and, once designated, NRSROs have for too long been allowed to operate without further scrutiny by the SEC for competence or accuracy.

By adopting this NRSRO system, the SEC thus established an insurmountable barrier to entry into the rating business, eliminating market competition among the rating agencies. No one could be surprised that once they were spared the market discipline, the quality of the work by protected rating agencies would diminish.

Market Behavior. Government policies that dominated and distorted the nation's housing market clearly set the stage for the housing crisis. But there were also significant mistakes made by private-sector participants at each step of the originate-to-distribute model of mortgage financing which compounded the government's failure. The benefits of this system—such a lower financing costs and the efficient distribution of risk—were significant. Over time, however, the belief that home prices would continue their relentless, upward path distorted began to distort decision making at every step along the path.

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[168] AEI Center for Regulatory and Market Studies, Lawrence J. White, *Lessons from the Debacle of '07-'08 for Financial Regulation and Its Overhaul* (Jan. 2009) (Working Paper No. 09-01).

The belief that real estate prices would only go up led borrowers, originators, lenders, securitizers, and investors to conclude that these investments were risk free. As a result, the traditional underwriting standards, based on the borrower's character, capacity to repay, and the quality of collateral were abandoned. What many failed to realize was that those standards were designed not only to protect the participants in the system from the consequences of a bubble, but also to protect the underlying financial system itself.

Borrowers. Building on that belief that housing prices could never go down, borrowers were encouraged to borrow as much as possible and buy as much house as they possible could, or else invest in other properties that could always later be resold for a profit. The result was that borrowers often ended up with mortgage products that they failed to understand, that they could not afford, or that ended up exceeding the value of the property securing the mortgage. Those concerns were less important as property values continued to rise, since borrowers could always refinance or sell to benefit from the continued appreciation of the property. However, when property values began to fall, in many cases borrowers soon realized that the economically rational course of action for them was to mail in their keys to the mortgage servicer and simply walk away. Since mortgages are non-recourse loans, doing so meant that someone else was bearing the downside risk. While the vast majority of borrowers continue to honor their commitments and pay their mortgages, for many of those who put little or no money down their mortgages became a "heads I win, tails you lose" proposition.

Mortgage Originators. Because mortgage originators were compensated on the quantity rather than the quality of loans they originated, there was little incentive to care if the loans they originated would perform. The compensation of mortgage brokers was also tied to the interest rates and fees paid by customers, which created a financial incentive for some brokers to direct borrowers to loans that may not have otherwise been in their best interest. For example, some originators who advocated for certain subprime loans received commissions that were more than twice as high as the commissions they would have received for higher-quality loans. This incentives model put a much higher premium on quantity over quality, which only diminished the safety and soundness of the entire system as even more risks were externalized while profits were internalized.

Mortgage Fraud. Integral to understanding the root causes of our current credit crisis is an acknowledgement of the rampant mortgage fraud that took place in the mortgage industry during the boom years. Fueled by low interest rates and soaring home values, the mortgage industry soon attracted both unscrupulous originators as well as disingenuous borrowers, resulting in billions of dollars in losses. As early as 2004, FBI officials in charge of criminal investigations foresaw that mortgage fraud had the potential to mushroom into an epidemic. In 2008, the Department of Treasury's Financial Crimes Enforcement Network (FinCEN) announced a 44 percent increase in Suspicious Activity Reports from financial institutions reporting mortgage fraud, with some 37,313 mortgage fraud reports filed in 2006, and 52,868 mortgage fraud reports filed in 2007. According to FinCEN, mortgage loan fraud was the third most prevalent type of suspicious activity reported, lagging behind only money laundering and check fraud. From 2000 to 2007, FinCEN found that the reporting of suspected mortgage loan fraud had increased an astounding 1400 percent from 3,515 cases in 2000 to 52,868 cases in 2007.[169]

[169] Financial Crimes Enforcement Network, *FinCEN Assessment Reveals Suspected Mortgage Loan Fraud*

Unfortunately, law enforcement officials failed to stop the epidemic that they had accurately diagnosed because they did not devote adequate resources to the problem. Even though the FBI and the Justice Department are charged with the responsibility of investigating and prosecuting illegal activities by originators, lenders, and borrowers, the focus of those agencies was trained on national security and other priorities. As a result, inadequate attention was paid to many of the white-collar crimes that contributed to the financial crisis. For example, by 2007, the number of agents pursuing mortgage fraud shrank to around 100.[170] By comparison, the FBI had about a thousand agents deployed on banking fraud during the S&L bust of the 1980s and 1990s. Although the FBI later increased the number of agents working on mortgage fraud to 200, others have pointed out that the agency might have averted much of the problem had it heeded its own warning about widespread mortgage fraud.[171]

Lenders. The belief that housing prices would rise forever, coupled with the ability to package loans for sale to investors, profoundly changed the way in which lenders underwrote loans. While underwriting had traditionally been based on the borrower's ability to repay a loan, as measured by criteria such as employment history, income, down payment, credit rating, and loan-to-value ratios, rising home prices pushed lenders to abandon these criteria. Little concern was paid to the risks of this change, given that in a worst-case scenario, servicers could always foreclose upon a property to satisfy the mortgage in full. As a result, lenders pioneered new mortgage products, such as no-doc and low-doc loans, low- and no-down-payment loans, and innovations that took rising home prices for granted. That is not to say that these exotic products are illegitimate; each may have its own appropriate use for borrowers in specific circumstances. But the broad application of these tailored products to *any* person in *any* circumstance invariably led to some borrowers receiving loans that were wholly inappropriate for their needs and capacity to repay. The ability to securitize these loans further degraded lending standards by allowing lenders to shift the risk of nonperforming mortgages onto the investors that purchased securities built around these products. In a world in which lenders could securitize even the most poorly underwritten of mortgages, what mattered most to lenders was that the loan did not default within an agreed-upon period—typically 90 or 180 days. Whatever happened after that time was someone else's problem.

Securitizers. Securitizers pooled mortgages of all types and quality together to create complex and often opaque structured products from these loans, such as mortgage-backed securities (MBS) and collateralized debt obligations (CDO). Securitizers knew that some portion of the mortgages they securitized would fail, but they believed that by structuring these mortgages into securities with different levels of risk, they could effectively eliminate any risk from those defaults with the guarantee of safer, performing loans. This belief grew from the assumption that others along the chain—the mortgage brokers and lenders—had adequately underwritten the loans so that any defaults would be manageable, and that housing prices would never go down. Those false assumptions belied the fact remains that in any finance model, you can never eliminate risk from a system of lending; at best, you can hope to control it by offsetting smaller sections of riskier loans with larger sections of safer loans. But that risk, while controlled, is always there, a lesson which the

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Continues to Rise (Nov. 3, 2007).

[170] Richard B. Schmitt, *FBI Saw Threat of Loan Crisis*, Los Angeles Times (Aug. 25, 2008).

[171] *Id.*

entire financial system is currently experiencing firsthand.

Investors. Like so many others, private investors in pursuit of risk-free investments failed to appreciate that if housing prices could go up, they could also go down. Rather than performing their due diligence on these mortgage-backed securities, many investors put their faith in the rating agencies and other proxies, and did not fully appreciate the risks they faced. Some large institutions further compounded their mistakes by holding their mortgage investments off-balance-sheet, using a loophole set forth in the regulatory capital requirements that permitted them to hold low-risk investments in special investment vehicles or conduits. And other large institutions—such as the former investment banks—availed themselves of an exemption granted by the SEC that permitted them to ignore traditional debt-to-net capital ratios—traditionally 12:1—and lever up as much as 40:1.[172] It was in this way that the once highly sought but ultimately poorly underwritten mortgages came to be the "troubled assets" that have now caused the collapse of so many in our financial system. Using first the assumption, and by 2008 the proof, that the government would deem certain institutions that had gambled on these assets to be too big or too interconnected to fail, these institutions and their creditors succeeded in making the taxpayer the ultimate bag holder for the risks they took, demonstrating yet again that the standard governing the housing boom and bust was "heads I win, tails you lose."

Mark-to-Market Accounting. The boom and bust nature of the housing and financial markets in recent years was amplified by the application of financial accounting standards that required financial institutions to write down their MBS assets to "market value" even if no market existed. As a result, institutions that held mortgage-backed securities found themselves facing the withdrawal of financing, often forcing them to sell these assets at distressed or liquidation prices, even though the underlying cash flows of these portfolios might not have been seriously diminished. In a liquidity-starved market, more and more distressed sales took place, further pulling down asset prices. These declining prices in turn created more lender demands for additional collateral to secure their loans, which in turn resulted in more distressed sales and further declines in asset values as measured on a mark-to-market basis. The result was a procyclical engine which magnified every downward price change in a recursive spiral, all of which might have otherwise been avoided had the mark-to-market standard provided better guidance on how to value assets in non-functioning markets.

Summary. The financial crisis which has unfolded over the past two years has numerous causes, and decisions made in the private sector were, in many cases, unwise. But the failure of government policy and the market distortions it caused stand at the center of the crisis. Whether by the Federal Reserve's engineering an artificially low interest rate, Congress's well-intentioned but misguided efforts to expand home ownership among less creditworthy borrowers, or the GSEs' securitization and purchase of risky mortgage-backed securities, the federal government bears a significant share of the responsibility for the challenges that confront us today.

To address these challenges, what is needed most is not simply reregulation or expanded regulation, but a modernized regulatory system that is appropriate to the size, global reach, and technology used by today's most sophisticated financial service firms. At a time when our nation's economy desperately needs to attract new investment and restore the flow of credit to where it can be used

[172] Stephen Labaton, *Agency's '04 Rule Let Banks Pile on New Debt,* New York Times (Oct. 2, 2008).

most productively, we must at all costs avoid regulatory changes under the label "reform" that have the unintended consequence of further destabilizing or constricting our economy. We should carefully consider the so-called lessons of the subprime crisis to be sure that whatever changes we adopt actually address the specific underlying causes of the crisis. These reforms should require the participants in the financial system to bear the full costs of their decisions, just as they enjoy the benefits. They should also enhance market forces, add increased transparency, and strip away counterproductive government mandates.

Perhaps above all, we should avoid creating a system in which market participants rely upon an implicit or explicit government guarantee to bear the risk for economic transactions gone wrong. If the events of the past two years have demonstrated anything, it is that whenever government attempts to subsidize risk—from efforts to stabilize home prices to the latest government-engineered rescues of financial institutions deemed too big to fail—those efforts are usually costly, typically ineffectual, and often counterproductive. We should all know by now that whenever government subsidizes risk, either by immunizing parties from the consequences of their behavior or allowing them to shift risk to others at no cost, we produce a clear moral hazard that furthers risky behavior, usually with disastrous consequences.

Any regulatory reform program must recognize the ways in which government is part of the problem, and should guard against an overreaction that is certain to have unintended consequences. Perhaps Harvard economist Edward L. Glaeser put it best: "We do need new and better regulations, but the current public mood seems to be guided more by a taste for vengeance than by a rational desire to weigh costs and benefits. Before imposing new rules, we need to think clearly about what those rules are meant to achieve and impose only those regulations that will lead our financial markets to function better."[173]

Recommendations for Federal Regulatory Reform

Developing an agenda for reform is an inherently controversial enterprise. As with any suggested change, some will stand to benefit while others might be forced to adjust to the new realities of a different regulatory scheme. The recommendations contained here are not immune from this charge, and there will invariably be disagreement over the advantages and disadvantages of some of these proposals. However, we believe that the following recommendations remain true to our objectives of helping to make markets more competitive and transparent, empowering consumers with effective disclosure to make rational decisions, effectively policing markets for force and fraud, and reducing systemic risk.

In considering the appropriateness of each item, the devil will always be in the details regarding how any of these recommendations might be enacted. Even the best idea, if poorly implemented, would lose many of the potential benefits it might otherwise yield. Thus, these recommendations are best understood as conceptual proposals rather than specific instructions for how to improve our regulatory system.

Given the limited time and resources available to the Panel to conduct this review, in many cases

[173] Edward L. Glaeser, *Better, Not Just More, Regulation*, Economix (Oct. 28, 2008) (available at economix.blogs.nytimes.com).

there are still unanswered questions about certain aspects of these reforms and in some cases even a few qualified reservations between the authors. Nevertheless, we believe that each proposal contains clear benefits for our economy, and has been structured to avoid the potential for unintended consequences. They deserve open consideration and debate in the public arena, and the opportunity to stand or fall on their own merits—a fitting tribute to the competitive free-market system that we are dedicated to strengthening and preserving.

1. Reform the Mortgage Finance System. The current financial crisis originated in the mortgage finance system, and much of the resulting turmoil can be traced to government interventions in the housing sector which helped fuel a classic asset bubble. Reform must begin with Fannie Mae and Freddie Mac, the GSEs whose influence drove the deterioration of underwriting standards, growth in subprime mortgage backed securities, and whose subsidized structure will result in hundreds of billions of dollars in taxpayer losses. The mortgage origination market itself should also be improved by establishing clearer standards, transparency, and enforcement.

1.1 Re-charter the housing GSEs as mortgage guarantors, removing them from the investment business.

At the center of the need for reform are Fannie Mae and Freddie Mac. As Charles Calomiris and Peter Wallison of AEI recently wrote: "Many monumental errors and misjudgments contributed to the acute financial turmoil in which we now find ourselves. Nevertheless, the vast accumulation of toxic mortgage debt that poisoned the global financial system was driven by the aggressive buying of subprime and Alt-A mortgages, and mortgage-backed securities, by Fannie Mae and Freddie Mac. The poor choices of these two GSEs—and their sponsors in Washington—are largely to blame for our current mess."[174]

The GSEs fueled the housing bubble through their ever expanding appetite for increasingly risky investments that they held in their massive portfolios. They financed these investments by borrowing at low, subsidized rates, and over time the firms became ever more dependent on their high yields to meet their earning targets. At one time, Fannie and Freddie accounted for more default risk than all other U.S. corporations combined—default risk implicitly backed by the federal government.[175] These risks to the taxpayer and the financial system were obvious, and should have been dealt with long ago.

Now that the GSEs have been taken into conservatorship, Congress has the opportunity to ensure that the damage they inflicted will never be repeated. This can be accomplished in one of two ways. One option is for Congress to phase out the GSEs' government charter and privatize them over a reasonable period of time following a model similar to that of the successful Sallie Mae privatization a decade ago. Legislation to that effect was introduced in the 110th Congress and will likely be re-introduced in the current Congress. These firms can and should compete effectively in the financial service marketplace on a level playing field without implicit or explicit taxpayer guarantees.

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[174] *Blame Fannie Mae and Congress for the Credit Mess*, Wall Street Journal (Sept. 23, 2008).

[175] Peter Wallison, *Regulating Fannie Mae and Freddie Mac* (May 13, 2005) (online at www.aei.org/publications/pubID.22514/pub_detail.asp).

Alternatively, Congress could opt to recharter the GSEs as government entities whose only mandate is to guarantee and help securitize mortgages. Such a structure would remove them entirely from the investment business by prohibiting them from maintaining massive investment portfolios which have proven to be a tremendous source of systemic risk. In either alternative, Congress must avoid a return to the flawed public purpose/private ownership model that permitted the GSEs' shareholders to profit at taxpayer expense.

1.2 Simplify mortgage disclosure.
The events of the past year have made painfully clear that the vitality of our financial system depends on a well-functioning housing market in which borrowers are able and willing to abide by the terms of the mortgage contracts into which they have entered. Unfortunately, the needless complexity involved in obtaining a mortgage appears designed to keep borrowers from fully understanding these important agreements. One way to minimize this complexity is to place essential information for borrowers in a simple, one-page document that makes clear what borrowers need to know before they enter into what will be for many the biggest financial transaction they will ever undertake. This information will permit borrowers to make an appropriate decision regarding the costs and affordability of borrowing to buy a house. This one-page document would include such items as monthly payments, interest rate, fees, and possible changes in the amount of payments for adjustable rate mortgages including the maximum possible interest rate on the loan and the maximum monthly payment in dollars. The one-page document should also include the warning that home values can go down as well as up, and that the consumer is responsible for making the mortgage payments even when the price goes down.

1.3 Establish minimum equity requirements for government guaranteed mortgages.
Because federally guaranteed mortgages put the taxpayer on the hook for any potential associated losses, the taxpayer needs to be protected from opportunistic borrowers that might otherwise walk away from a mortgage if housing prices fall. One way to protect the taxpayer is require the borrower to provide a bigger downpayment. If the taxpayer is going to take on risk, it is only fair that the borrower share in that risk as well.

FHA loans currently require at least a 3.5 percent downpayment, which is clearly too low. The minimum downpayment for all government-insured or securitized mortgages should be raised immediately to at least 5 percent, and to as much as 10 percent or higher, over the next several years as market conditions improve. Lest the advocates of government-subsidized mortgages in which taxpayers bear the risk complain that 5 percent is too high, it bears pointing out that would still be *four times* as lenient as the 20 percent standard that was in place two decades ago.

1.4 Allow Federal Reserve mortgage lending rules to take effect and clarify the enforcement authority for mortgage origination standards.
In July 2008, the Federal Reserve approved a comprehensive final rule for home mortgage loans that was designed to improve lending and disclosure practices. The new Federal Reserve rule was designed to prohibit unfair, abusive or deceptive home mortgage lending practices, and it applies to all mortgage lenders, not just those supervised and examined by the Federal Reserve.

The final Federal Reserve rule adds four protections for "higher priced mortgage loans," which encompasses virtually all subprime loans. The final rule:

1. Prohibits lenders from making loans without regard to a borrower's ability to repay the loan.

2. Requires creditors to verify borrowers' income and assets.
3. Bans prepayment penalties for loans in which the payment can change during the first four years of the loan (for other higher-priced loans, a prepayment penalty period cannot last for more than two years).
4. Requires creditors to establish escrow accounts for property taxes and homeowner's insurance for all first-lien mortgage loans.

In addition, the Federal Reserve issued the following protections for all loans secured by a consumer's principal dwelling:

1. Creditors and mortgage brokers are prohibited from coercing a real estate appraiser to misstate a home's value.
2. Companies that service mortgage loans are prohibited from engaging in certain practices, such as pyramiding late fees.
3. Servicers are required to credit consumers' loan payments as of the date of receipt and provide a payoff statement within a reasonable time of request.
4. Creditors must provide a good faith estimate of the loan costs, including a schedule of payments, within three days of a consumer applying for a mortgage loan.

Finally, the rule sets new advertising standards, which require additional information about rates, monthly payments, and other loan features. It also bans seven advertising practices it considers deceptive or misleading, including representing that a rate or payment is "fixed" when it can change.

These new rules represent a change in federal regulation that, regardless of whether or not one agrees with the degree to which consumers might benefit from all of these rules, will significantly alter the way in which the mortgage lending industry operates. Thus, before policymakers succumb to the desire to write additional rules and regulations, they should allow the Federal Reserve's new guidelines to take effect, monitor their impact upon mortgage origination, and clarify the authority for enforcing these new federal standards. Additionally, for these new rules to work effectively, they must be appropriately enforced. In particular, Congress should ensure that federal and state authorities have the appropriate powers to enforce these laws, both in terms of resources and actual manpower, for all mortgage originators.

1.5 Enhance securitization accountability standards.

The advent of securitization has been a tremendous boon to the mortgage industry, and countless millions of Americans have directly or indirectly benefited from the liquidity it has created. Nevertheless, the communicative nature of loans in the securitization process has helped diminish accountability among market participants, eroding the quality of many loans. Thus, to restore accountability, minimum standards should be set for all loans that are to be securitized so that securitizers retain some risk for nonperforming loans.

One proposal would be to link the compensation securitizers receive for packaging loans into mortgage-backed securities to the performance of those loans over a five year period, rather than the six-month put-back period that is the current standard. This change in compensation would thus give the securitizer an economic stake in the loan's long-term performance, aligning the

securitizer's incentives with those of borrowers, investors, and the broader economy. Further, consideration should be given to applying additional limitations on the ability to securitize loans that carry with them an explicit government guarantee.

2. Modernize the Regulatory Structure for Financial Institutions. It has become a cliché to observe that if one were designing a regulatory system from scratch, one would not come up with the patchwork system of agencies with overlapping jurisdictions and conflicting mandates. The U.S. financial regulatory system is fractured among eleven federal primary regulatory agencies in addition to scores of state regulatory agencies. The system developed over a 200-year period, during which institutions largely lacked the ability to transact business nationwide, let alone globally. Insurance, securities, and bank products were sold by different institutions, and little cross-market competition existed.

During the past thirty years, changes in size and technology have opened financial markets to buyers and sellers around the globe, transaction times are now measured in fractions of a second, and consumers have been given access to a broad range of valuable products from a single provider. Innovations in products and technology, and the global nature of financial markets are here to stay. An unnecessarily fragmented and outdated regulatory system imposes costs in several ways: inefficiencies in operation, limitations on innovation, and competition restraints that are difficult to justify.

2.1 Consolidate federal financial services regulation.
The benefits of a more unified federal approach to financial services regulation have been a constant theme in proposals for regulatory reform, some of which were under consideration and announced before the onset of the current financial crisis. For example, the Group of 30, in its very first recommendation, called for "government-insured deposit taking institutions" to be subject to "prudential regulation and supervision by a single regulator."[176] The Committee on Capital Markets Regulation has similarly called for a consolidated U.S. Financial Services Authority (USFSA) that "would regulate all aspects of the financial system including market structure and activities and safety and soundness."[177] Treasury's Blueprint for a Modernized Financial Regulatory Structure recommends a Prudential Financial Regulatory Agency (PFRA) with oversight over "financial institutions with some type of explicit government guarantee associated with their business operations."[178]

The current regulatory structure for oversight of federally chartered depository institutions is highly fragmented, with supervision spread among at least five agencies including the OCC, OTS, FDIC, National Credit Union Administration (NCUA), and the Federal Reserve. Thus, Congress should streamline oversight of these federally chartered and insured institutions.

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[176] The Group of 30, *Financial Reform: A Framework for Financial Stability* (Jan. 15, 2009) (online at www.group30.org/pubs/recommendations.pdf).

[177] The Committee on Capital Markets Regulation, *Recommendations for Reorganizing the U.S. Financial Regulatory Structure* (Jan. 14, 2009) (online at www.capmktsreg.org/pdfs/CCMR%20-%20Recommendations%20for%20Reorganizing%20the%20US%20Regulatory%20Structure.pdf).

[178] U.S. Department of Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (Mar. 31, 2008) (online at www.ustreas.gov/press/releases/reports/Blueprint.pdf) (hereinafter "Blueprint").

2.2 Modernize the federal charter for insured depository institutions.
There are many kinds of insured depositories operating under unique charters including national banks, thrifts, state chartered members of the Federal Reserve system, state chartered nonmembers, credit card banks, federal and state credit unions, and state charted industrial loan corporations. While this vast array of institution type may have had a sound historical basis, changes in the national economy and regulatory landscape have made many of these differences functionally obsolete. Although regulatory competition can prove beneficial, the current state of duplicative banking regulation has several negative consequences as well, including unnecessary consumption of federal regulatory resources, consumer transparency, and differences in charters for largely similar institutions, which can lead to unfair competitive advantages for institutions governed by certain charters over others.

In particular, the OCC and the OTS play a very similar role for two classes of depository institutions which were once were quite different in nature, but now compete for the same customers, offering similar services. The thrift charter was originally instituted to foster the creation of financial services organizations to encourage home ownership by ensuring a wide availability of home mortgage loans. Due to a number of national policy changes that have been instituted over the last several decades to encourage homeownership and the decreasing share thrifts have of the residential mortgage market in relation to commercial banks, a unique thrift charter is no longer necessary to meet this goal. Moreover, the constraints of the thrift charter limit the diversification of thrifts' loan portfolios, which only exacerbates their ability to remain financially healthy in a weak real estate market.

Many individuals and organizations reviewing the current regulatory landscape have come to the conclusion that these agencies, and their corresponding federal thrift, and federal bank charters should be unified. In fact, back in 1994, former Federal Reserve Governor, John P. LaWare recommended combining the OCC with the OTS.[179] Similarly, in 1996, the GAO recommended that primary supervisory responsibilities of the OTS, OCC, and the FDIC be consolidated into a new, independent Federal Banking Commission.[180]

Congress should consider other steps to modernize and rationalize the federal charter system. Each class of charter should be reviewed for purpose, structure, cost and distinct characteristics. Unnecessary differences are potential sources of confusion, conflict, or taxpayer risk, and should be eliminated wherever possible.

2.3 Consolidate the SEC and CFTC.
Similar to the rationalization that is needed in banking regulation, consolidation of securities regulation in the U.S. through the merger of the SEC and the CFTC should also be undertaken. Most countries have vested the power to oversee all securities markets in one agency, and for good reason—more efficient, consistent regulation that protects consumers in a more uniform manner.

As the Treasury Blueprint states: "Product and market participant convergence, market linkages,

[179] Walter W. Eubanks , U.S. Congressional Research Service, RL33036, , *Federal Financial Services Regulatory Consolidation: An Overview* (July 10, 2008), at 14.

[180] Government Accountability Office, *U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure* (Nov. 1996) (online at www.gao.gov/archive/1997/gg97023.pdf).

and globalization have rendered regulatory bifurcation of the futures and securities markets untenable, potentially harmful, and inefficient. The realities of the current marketplace have significantly diminished, if not entirely eliminated, the original rationale for the regulatory bifurcation between futures and securities markets."[181]

It further notes that: "Jurisdictional disputes have ensued as the increasing complexity and hybridization of financial products have made 'definitional' determination of agency jurisdiction (i.e., whether a product is appropriately regulated as a security under the federal securities laws or as a futures contract under the CEA) increasingly problematic. This ambiguity has spawned a history of jurisdictional disputes, which critics claim have hindered innovation, limited investor choice, harmed investor protection, and encouraged product innovators and their consumers to seek out other, more integrated international markets, engage in regulatory arbitrage, or evade regulatory oversight altogether."[182]

In testimony before this panel, Joel Seligman, President of the University of Rochester and a leading authority on securities law, agreed, stating, a "pivotal criterion to addressing the right balance in designing a regulatory system is one that reduces as much as is feasible regulatory arbitrage. Whatever the historical reasons for the existence of a separate SEC and CFTC, the costs of having a system where in borderline cases those subject to regulation may choose their regulator is difficult to justify."[183]

The most significant obstacle to this proposal is a political one. Congressional oversight of the two agencies is split between two committees in both the House and Senate. Consolidation would most likely mean that one committee would lose out, leading to a classic turf war. Since the nature of futures trading has evolved significantly over the years, and is now dominated by non-agricultural products, the Senate Banking and House Financial Services Committees would be the appropriate venue for all congressional securities oversight.

2.4 Establish an optional federal charter for national insurance firms.
The U.S. federal financial service regulatory infrastructure contains no agency or organization responsible for oversight of national insurance firms. As far back as 1871, regulators saw the need for uniform national standards for insurance. That year, former New York Insurance Commissioner, George W. Miller, who founded the National Association of Insurance Commissioners (NAIC), made the following statement: "The Commissioners are now fully prepared to go before their various legislative committees with recommendations for a system of insurance law which shall be the same in all States, not reciprocal but identical, not retaliatory, but uniform."[184] That need for uniform standards has grown quite considerably during the past 138 years.

Congress should institute a federal charter that may be utilized by insurance firms to underwrite,

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[181] Blueprint, *supra* note 178.

[182] *Id.*

[183] Seligman, *supra* note 18.

[184] House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of Rep. Sue Kelly, *NARAB & Beyond: Achieving Nationwide Uniformity in Agent Licensing*, 107th Cong. (May 16, 2001) (online at financialservices.house.gov/media/pdf/051601ke.pdf).

market, and sell products on a national basis. While individual state insurance regulators have effectively managed state guarantee pools, as well as safety and soundness within their jurisdiction, they simply are not equipped to effectively oversee a global firm such as AIG, which had 209 subsidiaries at the time the federal government acted to prevent its collapse in the fall of 2008. Of the 209 subsidiaries, only twelve fell under the jurisdiction of the New York insurance commissioner, which was effectively AIG's primary regulator.[185]

By allowing insurance firms to choose between a unified national charter or maintaining operations under existing state regulation, Congress can build upon the success of state guarantee pools and maintain state jurisdiction over premium taxes. A national charter would also allow regulators to take a comprehensive view of the safety and soundness of large insurance companies and to better understand the potential risks they may pose to the strength of the broader U.S. economy. Lastly, a federal insurance regulator would be able to implement effective consumer protection, provide a clear federal voice to coordinate global insurance regulation with foreign counterparts, and ensure appropriate access for U.S. insurance companies in overseas markets.

3. Strengthening Capital Requirements and Improving Risk Management. The experience of the past two years demonstrates that our financial system was far more susceptible to shocks from the housing sector than it should have been, as a result of capital requirements that were insufficient to sustain financial institutions in time of stress. Those weaknesses were in turn further exacerbated by certain standards and practices, such as a heavy reliance on credit rating agencies and the application of mark-to-market accounting standards. To ensure that our financial system can better withstand these kinds of shocks, capital requirements should be strengthened and risk management should be enhanced.

3.1 Strengthen capital requirements for financial institutions.
One of the key lessons that has emerged from this crisis is that our financial institutions did not have adequate capital reserves to weather the turmoil in the housing market due in large part to the fact that many of the assets they held were inextricably linked to this market. One way to address this problem would be to ensure that regulators can demand that financial institutions increase their capital during flush times. Those reserves could then serve as a cushion during bad times when capital is much harder to raise. The provisioning requirements would be based on the health of the economy as a whole, thus building upon systemic strength and buffering against systemic weakness.

These countercyclical requirements would be quite different from those governing the regulatory capital that financial institutions are required to hold today. The current capital rules for lending are out of date, subject to manipulation, and do not accurately reflect the risks associated with lending activities. That said, there are also significant flaws and risks associated with the new capital rules called for by the Basel II regime.

Much of the initial modeling now available suggests that average capital requirements for banks subject to Basel II methodologies would decrease. The determination to allow the largest and most complex banks to use internally developed, historical models for the purpose of determining capital risk charges merits further and closer scrutiny. Given the current financial crisis and the federal

[185] John Sununu, et al., *Insurance Companies Need a Federal Regulator*, Wall Street Journal (Sept. 23, 2008) (online at online.wsj.com/article/SB122212967854565511.html).

guaranty on deposits that banks enjoy, weak capital requirements called for by Basel II could leave taxpayers on the hook yet again.

3.2 End conduits and off-balance-sheet accounting for bank assets.
Apart from its procyclicality, Basel II permitted banks and other financial institutions to keep assets such as mortgage-backed securities off their books in conduits or structured investment vehicles on the grounds that these assets were high-quality and low-risk. Even if such an assessment were accurate—and the past two years have demonstrated that it was not—off-balance-sheet arrangements such as this permit financial institutions to game the regulatory requirements in place. These off-balance-sheet arrangements were made even more dangerous by the perception that their liabilities were implicitly guaranteed by the institutions that sponsored them, which permitted even greater leverage to build before the credit crisis hit. Thus, all assets and liabilities of a financial institution should be held on the balance sheet. If nothing else, one of the lessons of this credit crisis is the necessary steps should be taken to eliminate the notion of an "implicit guarantee" of anything in our markets.

3.3 Adjust the application of mark-to-market accounting rules.
Fair value accounting should be revised and reformed. As things stand now, the accounting rules magnify economic stress and can have serious procyclical effects. When markets turn sour or panic, assets in a mark-to-market accounting system must be repeatedly written down, causing financial institutions to appear weaker than they might otherwise be. A superior accounting system would not require financial institutions to write down their assets at a time when prices have fallen precipitously during a rapid downturn as in the collapse of a bubble. Thus, alternative asset valuation procedures—such as discounted cash flow—should be used, and it should be made easier for financial institutions to declare assets as held-to-maturity during these periods. In normal markets, prices will fluctuate within a limited range, and will rise slowly if at all. But in times of crisis—such as the one we are facing—write-downs beget fire sales, which beget further write-downs.

In late September 2008, the SEC released guidelines that allowed companies greater flexibility in valuing assets in a nonfunctioning market. Such changes are encouraging. Moving forward, accounting rules have to provide transparency and the most accurate depiction of economic reality as possible. It is for the best that the development of accounting rules should not be conducted in the political arena. However, it is clear that the rules need to be improved, taking into account the lessons learned from recent events. Ultimately, greater transparency and accuracy in accounting standards are necessary to restore investor confidence.

3.4 Eliminate the credit rating agencies' cartel.
The failure of the credit rating agencies in the financial crisis could not be more apparent. Much like the GSEs, the credit rating agencies benefited from a unique status conferred upon them by the government. They operated as an effective oligopoly to earn above-market returns while being spared market discipline in instances where their ratings turned out to be inaccurate. The special status of the rating agencies should be ended so as to open the ratings field to competition from new entrants and to encourage investors and other users of ratings not to rely upon a ratings label as a substitute for due diligence.

3.5 Establishing a clearinghouse for credit default swaps

Despite recent criticism heaped upon them, the thriving credit default swaps (CDS) market demonstrates the valuable role that innovation plays in improving the functioning of our financial markets. Through the use of CDS, investors and lenders can hedge their credit exposures more efficiently, thereby freeing up additional credit capacity, which has in turn enabled banks to expand credit facilities and reduce costs of funds for borrowers. CDS have enabled asset managers and other institutional investors to adjust their credit exposures quickly and at a lower cost than alternative investment instruments, and have enabled market participants to better assess and manage their credit. CDS have also enabled market participants to value illiquid assets for which market quotations might not be readily available.

Despite their many benefits and the crucial role that CDS have come to play in the financial system in managing risk, legitimate concerns have arisen regarding the transparency of the system and the management of counterparty risk. To address these concerns, the Federal Reserve, the CFTC, and the SEC have recently agreed on general principles to provide consistent oversight of one or more clearinghouses for CDS trades. The proposed guidelines will result in more public information on potential risks being provided to counterparties and investors, as well as the mitigation of any systemic losses caused by potential fallout from the CDS market.

These principles constitute a valuable first step in creating a CDS clearinghouse and will further improve a product that has thus far proven invaluable in managing risk when prudently used. A properly structured clearinghouse, capitalized by its members, spreads the risk of default and fosters market stability by acting as the sole counterparty to each buyer and seller. A clearinghouse will allow performance risk to be isolated to net exposure, rather than related to the much larger gross positions in the market.

A number of reforms have already reduced risk in the CDS market. The CDS market has already dramatically increased margin, mark-to-market and collateral requirements for hedge funds and other investment institutions on the other side of any trade. And at the behest of the New York Federal Reserve and other regulators, record keeping has improved; trade confirmations, for example, now must be tendered quickly. Buyers of CDS protection now also must formally approve any switch of their coverage from one insurer to another. Previously, the insured might not know who was its latest counterparty.

A clearinghouse, however, may not be appropriate for the most complex and unique over-the-counter derivatives. Moreover, because a clearinghouse arrangement spreads risk to other market participants, it could encourage excessive risk taking by some, especially if risks associated with more exotic products are not priced properly due to information asymmetry. Policy makers and regulators should continue to work with the private sector to facilitate a CDS clearinghouse that provides greater transparency and reduces systemic risk in the broader financial markets.

4. Address Systemic Risk.

4.1 Consolidate the Work of the President's Working Group and the Financial Stability Oversight Board to create a cross-agency Panel for identifying and monitoring systemic risk.

Systemic risk can materialize in a broad range of areas within our financial system: at both depository and nondepository institutions, within either consumer or commercial markets, as a result of poor fiscal or monetary policy, or initiated by domestic or global activity. Thus, it is impractical, and perhaps a dangerous concentration of power, to give one single regulator the power

to set or modify any and all standards relating to such risk. Systemic risk oversight and management must be a collaborative effort, bringing together the leading authorities for addressing safety and soundness, managing economic policy, and ensuring consumer protection.

One alternative to a single systemic risk regulator would be to develop a panel of federal agencies to consider jointly these important questions. The Presidential Working Group (PWG) was established after the stock market crash of 1987 to make recommendations for enhancing market integrity and investor confidence. Similarly, the Financial Stability Oversight Board (FSOB) was established under the EESA in 2008 as a cross-agency group to oversee the Troubled Assets Relief Program (TARP) and evaluate the ways in which funds might be used to enhance market stability. Both groups include the Treasury, the Federal Reserve, and the SEC. The PWG adds the CFTC, while the FSOB includes the Housing Secretary and the Director of the Federal Housing Finance Agency (FHFA), which oversees the housing GSEs.

While the quarterly evaluation of TARP operations provided by the FSOB will continue through the life of the program, the broad mission and structure of these two organizations are, in many respects, redundant. Moreover, they represent the collaborative, cross-agency structure that would best provide insight in to the practices, policies, and trends that might contribute to systemic risk within the financial system.

By combining and refocusing the efforts of these two organizations, Congress can establish a body with the requisite tools to identify, monitor, and evaluate systemic risk. The panel can make specific legislative recommendations, as well as encourage immediate action consistent with the significant regulatory powers already vested in its members.

A Panel comprised of the Federal Reserve, the Treasury, the primary regulator of federally insured depository institutions, and the combined SEC/CFTC, would have authority to access detailed financial information from regulated financial institutions, require disclosure of information necessary to evaluate risk, and require that financial institutions to undertake corrective actions to address systemic weakness.

Disagreement with Panel Regulatory Recommendations

In far too many areas, the Panel Report offers recommendations or policy options that are rife with moral hazard and the potential for unintended consequences. Given that some of the principal causes of this financial crisis include the moral hazard embedded in the charter of Fannie Mae and Freddie Mac, market-distorting housing mandates like the CRA, and the unintended consequences of a credit rating agency certification process which restricted competition, we must be particularly mindful of these risks. In some cases, a highlighted action may appear benign, but the more detailed summary includes proposals or policy "options" that cannot be supported.

Other sections, such as those dealing with systemic risk and leverage, include highly proscriptive proposals that would be difficult, if not impossible to implement outside the walls of academia. Finally, the Panel Report all but ignores the critical role played by the Federal Reserve's highly accommodative monetary policy, and the host of troubles created by the government charter and implicit backing of the GSEs. Avoiding discussion of such important components of the crisis will inevitably lead one to set the wrong priorities for reform. While not exhaustive, the following represents a list of the more significant disagreements held with the Panel Recommendations for

Improvement:

1. The Panel Report calls for a "body to identify and regulate institutions with systemic significance" and "[i]mpose heightened regulatory requirements for systemically significant institutions." The recommendations suggest that firms designated as such are to be subjected to unique capital and liquidity requirements, as well as special fees for insurance. Although it is important that regulators work to identify, monitor, and address systemic risk, such explicit actions are more likely to have unintended and severe negative consequences.

Publicly identifying "systemically significant institutions" will create significant moral hazard, the cost of which will far outweigh any potential regulatory benefits. Consider the two possible effects of being identified as such. First, in one case, the cost and burdens of additional capital and regulatory requirements (as recommended) place a firm at a competitive disadvantage relative to its peers. Thus, the competitive strength of a systemically significant firm is impaired, raising the probability of a business failure—an undesirable outcome.

In the alternative case, the market may view designation as a *de facto* guarantee of public support in during times of financial stress. The firm attains a beneficial market status, and enjoys advantages such as a lower cost of capital in the public markets. The costs of failure are thus socialized, while profits remain in private hands (much as was the case for the GSEs, Fannie Mae and Freddie Mac). Recent events make clear that this scenario is perhaps an even more undesirable outcome than the former.

Unfortunately, these are the only two practical outcomes of any designation—either markets will view it as a competitive burden or as a competitive advantage. It is unrealistic to argue that such a "significant" designation would be viewed as competitively neutral. Moreover, it is unreasonable to assume that government will manage the potential moral hazard more effectively than was done in the case of the GSEs.

2. The Panel Report recommends the formation of "a single federal regulator for consumer credit products." Such an action would isolate the activity of creating and enforcing consumer protection standards from oversight of safety and soundness in financial institutions.

The regulation of any federal financial firm requires the balancing of multiple policy choices and should be done by one institution. Experience has shown us with the GSE model that having two stated goals, one for safety and soundness and one for social policy, inherently will lead to conflict. Since the new consumer product regulator would be able to affect all financial institutions, eventually those rules will conflict with a bank's profitability, capital levels, and ultimately, solvency. Under this Panel proposal, an independent agency would have power to impose regulations that could well undermine the health of banks, but would not be responsible for the safety and soundness of those banks.

This balance is of particular significance within institutions that have been provided with explicit taxpayer funded guarantees, such as FDIC insurance. By placing both responsibilities with the same regulator, greater assurance is provided that taxpayer interests will not be placed in jeopardy by regulations that unnecessarily weaken capital or competitive position.

3. The Panel Report broadly calls for the adoption of new regulations to "to curtail leverage." While

the recommendation implies that regulators across the spectrum of financial institutions set inappropriate standards for leverage, this simply is not the case.

Few, if any, observers of the current crisis have argued that capital standards set by the FDIC and other federal and state banking regulators overseeing depository institutions were set at dangerously low levels. To the extent that FDIC insured institutions have become troubled, it has been largely the results of deteriorating loan quality. Thousands of such institutions across the country remain strong and healthy. Raising their capital standards now in an effort to "curtail leverage" would be highly procyclical and would sharply limit the availability of credit for consumers and businesses.

Without question, there were some financial firms, notably non-depository institutions such as broker-dealers, that were allowed to raise their leverage ratios substantially in recent years. The SEC ruling issued in 2004, which allowed alternative net capital requirements for broker-dealers, contributed significantly to the failures of both Bear Sterns and Lehman Brothers. The regulatory decision to rely on internal models for risk weighting assets appears, in retrospect, to have been a major miscalculation.

Moreover, prudent regulators may wish to consider adopting capital policies that are more counter-cyclical as well, to encourage the building of stronger reserves during good times and ensure greater stability in periods of financial stress. Blanket mandates to "curtail leverage," however, will only restrict access to credit and limit successful lending models where they are needed most.

4. The Panel Report argues that: "Hedge funds and private equity funds are money managers and should be regulated according to the same principles that govern the regulation of money managers generally." The recommendation fails to recognize the important distinctions between investment firms and fails to explain why these distinctions should be ignored.

There exist clear and dramatic differences between managing capital allocation on behalf of a $5 billion dollar pension fund, and investing funds placed in a personal IRA or 401k. Under current law, private equity, venture capital, and hedge funds may not be marketed to retail investors. While they remain subject to all regulations regarding trading and exchange rules and regulations, they are not subject to the marketing and registration requirements designed to protect smaller, unsophisticated investors, because they do not serve that market.

Suggesting that more regulation should be imposed on these entities in light of the current crisis ignores the fact that even under the tremendous financial upheaval of the past year, no major hedge funds have declared bankruptcy, and taxpayers have been exposed to no losses resulting from failed hedge fund or private equity investment activity.

Finally, it may be worth noting that several high-profile hedge fund management firms were among the first to publicly and accurately assess the dangers inherent in the housing finance system, mortgage backed securities, and Fannie Mae and Freddie Mac.

5. The Panel Report call for Congress to "[e]liminate federal pre-emption of application of state consumer protection laws to national banks." Such a change would effectively defeat the purpose of a uniform federal charter for insured depository institutions.

As previously mentioned, the regulation of any federal financial firm requires the balancing of

multiple policy choices and should be done by one institution. By giving state regulators the power to affect bank profitability, capital levels, and solvency standards, this proposal would greatly enhance risk and curtail innovation in our system. Under the Panel proposal, states would not be responsible for the safety and soundness of federally chartered banks, but would have authority to impose regulations that could well undermine the health of those banks.

Allowing states to impose their own consumer protection laws also undermines the fundamental purpose of a federal banking charter. Congress established federal financial charters to enable firms to offer products and services on a uniform national basis. Standardization of products and services lowers costs, and acts as an incentive for innovation by enabling new products to be brought to market sooner. Allowing every state to impose its own set of product or business standards on national banks would represent a step backwards, away from strong well-balanced federal regulation that allows national firms to compete effectively with global peers.

6. The Panel Report calls for new "tax incentives to encourage long–term-oriented pay packages," which would represent an unprecedented intervention in the operation of private employment markets.

The Federal Government should not structure the tax code to reward, penalize or manipulate compensation. Congress attempted to do this in the Omnibus Reconciliation Act of 1993, Pub..L. No. 103-66, which contained the so-called "Million-Dollar Pay Cap."[186] It not only failed to achieve the stated goals of its authors, it had unintended consequences: by raising taxes on cash compensation, more firms chose to compensate executives with large packages of stock options, resulting in numerous high-profile multimillion-dollar "pay days" when the options were exercised.

Compensation committees should establish executive pay policies that are fair, encourage sound long-term decisions, and are fully disclosed to shareholders and the public. Using the tax code to design an ideal pay structure will certainly have unintended negative consequences, as has been demonstrated by past action, nor will it be successful in deterring companies from paying their employees what they wish to attract and retain the best available talent.

7. The Panel Report calls upon Congress to "consider creating a Credit Rating Review Board" which would be given the sole power to approve ratings required by pension fund managers and others to purchase investment securities.

The credit rating system is badly in need of reform, but the main weakness in the current system has been the existence and operation of, effectively, a duopoly—a status created by the restraints of the government certification process. Giving a government operated Credit Review Board the power to sign off on all credit ratings brings the system to a single point of failure, and becomes a significant source of systemic risk. Improving the credit rating system will require more competition, an elimination of conflicts, and accountability. Regulators can facilitate this accountability by tracking the default levels of rated securities over time, and publicly disclosing the best and worst rating agency performance.

[186] Omnibus Reconciliation Act of 1993, Pub. L. No. 103-66, at § 13211.