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Congressman Barney Frank
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Thank you. Thank you on the very lovely introduction, and I did escort Robert McNamara through the steam tunnels ending, coming out by the way, right across the street in the gulch, we used to call it, between Kirkland and Eliot Houses – the steam tunnels come out at Eliot House. What the Dean graciously omitted to mention is that I was in charge of making sure that that didn't happen so yes, I did, kind of like the arsonist who comes to put out the fire, I did get him out of a mess that I was supposed to have prevented. He was wonderfully gracious about it.

I am glad to have this opportunity to speak here and talk about what's really an extraordinarily important subject. We are in, I think, a period in public policy comparable to the turn of the twentieth century and the New Deal, in this regard. There's a pattern in economic events, let me say some of my conservative friends, it's now become in their effort to find ways to tarnish the Obama administration – they have accused him of being a socialist or leading to socialism. And before the House last week one of the leaders the conservative Republicans said wasn't it ironic that even the socialists in Europe were denouncing him for spending too much. I did point out that in fact the socialist leading figure in Europe, Gordon Brown, was on his side and it was the conservatives in Germany and in France who were denouncing him. The response was, oh well, you're much better at finding socialists than I, and my counter-response was that a blind dart thrower would be better at finding socialists. This throwing around of socialism is an example of the bankruptcy of thought.

What we are faced with is for the third time that I can think of the need for public policy to step in and help rescue the private market from its own excesses so it can do its job better. As a recurrent pattern, we're obviously a private sector society and we depend on the private sector for the creation of wealth. And innovation in the private sector is very important. At various points the degree of innovation becomes almost qualitative and you have this situation – there are new economic phenomena or activities that produce a great deal of value but because they are new they are operating in a climate without any rules and any regulation so they also create harm. And the job of public policy is to come up with a framework of rules and regulations that diminish the abuses while maximizing the value.

In the late nineteenth century, we saw the formation of large industrial enterprises – the trusts --without which we would not have been able to spread wealth. Ma and Pa and small enterprises weren't going to be able to do it. So they produced a lot of wealth. They also produced a lot of abuses. And Theodore Roosevelt and Woodrow Wilson spent a good part of their administrations trying to come up with rules that gave us the benefit of these large industrial enterprises but contained the harms. So you've got the anti-trust acts, you've got the Federal Trade Commission, you ultimately got the Federal Reserve, you've got the Food and Drug Administration.

That worked well, for a while. But of course these large enterprises meant that you needed a finance capitalism – you needed a stock market. You were well beyond what any small group of individuals could do to finance economic activity. And so the stock market bloomed and it does a lot of good, but it has a pattern of abuse. And much of the Franklin Roosevelt administration was creating entities that give the benefit of a vigorous stock market while diminishing the abuses. By the way, if you want to read about how regulation chokes off enterprise, you get tired of some of the right-wing commentators today, go to the Congressional Record in the thirties and read what they have to say about the establishment of the Securities and Exchange Commission or other legislation back then. And the fact is that what Roosevelt did was to set rules to govern the stock market activities so that we got the benefit and not the harm.

We go forward now, maybe sixty years, to the nineties and there is a new set of economic phenomena – deceptively simple - I think it really comes down to one central fact and that's the ability to make loans outside of the banking system and then to take the loans and sell them to other people. The process is securitization.

Thirty years ago if you got a mortgage, you got it from a banker, who expected you to pay him or her back and frisked you pretty good to make sure you were going to do that. I got to the Legislature in 1973 and the community bankers said our motto is: "know your banker." Two things happened. First of all, large pools of money in the world available now outside of the depositor bank system. Until fairly recently, the only way you were going to accumulate enough money to make all those loans was through a bank because a lot of depositors gave you the money and the banks intermediated that. But then because of international activity, oil, trade, large pools of money became available for loans outside of the banking system. They were not regulated by that because the major constraint against loans being made irresponsibly is the desire to be repaid. But securitization technology and outside the banking regulatory system makes it possible for you to make the loans, sell the loans and be somewhat less concerned about whether they are repaid.

Now it's interesting, years ago the view was that debt was for stodgy people and equity was volatile. We've reversed that. The great volatility has been in debt because increasingly loans have been made – and the percentage of loans that are made by banks – technical banks – entities that take deposits, are deposit insured and are regulated – the percentage of loans that they make has gone way down and what has happened is that loans are being made by institutions that are lightly if at all regulated and they are then sold one hundred percent. And that, I believe, is the cause of the problem – it was particularly the problem with regard to subprime loans.

But our job today is very similar, it seems to me, to what Theodore Roosevelt and Woodrow Wilson did, I know there's a debate whether Taft did or didn't do it and I'll stay out of that, what Franklin Roosevelt did, namely preserve innovation – securitization is a good thing. If a banker makes a loan or if somebody makes a loan on a mortgage and has to wait for that to be repaid for many years that money can't be re-lent. If it is securitized, if the loan is immediately sold, that's money for more lending so that's a good thing -- but not if the loans were bad loans. The key here was in particular mortgage loans. This is the central piece and there's general agreement it was the making of irresponsible mortgage loans that was the problem. Now our job, as I said, is to put some rules in place and I want to stress again these are pro-market rules.

One of the problems we have today is that people don't want to invest because they have been so badly burned. That was one of the things that Franklin Roosevelt did – he put some rules in so it was safe to invest in the stock market. We have a problem today where investors are afraid to invest. We know the story of the child who touches the hot stove and gets burned and learns it's not a good thing to touch the hot stove again. The problem we have today is that people, having touched the hot stove, won't touch the hot stove again, or the sink, the bathtub or the toilet either. We have to get people a way to differentiate between good and dangerous white porcelain. That's the role of public sector activity – it's to give people some assurances. Franklin Roosevelt made the stock market a much safer place in which to invest and a much more efficient place because of it. We want to do the same thing with securitization.

Now my friends on the right are very angry about this because they see correctly coming a wave of increased pro-market regulation. I believe we are talking about regulation that enhances the market, that recognizes the importance of a private market but helps it function better. But this is ideologically something to which they are very opposed. Some of them, I must tell you, honestly believe that this is a lack of freedom – the road to serfdom, Von Mises and Hayek.

I have to say here there are a large number of supporters of those views in Congress. Fascinating, however they are all for free enterprise and keeping the government out of economic activity and not getting involved in this sort of regulation apparently except where it comes to agricultural subsidies. And there may be somebody here who knows it but I don't myself read German and don't often understand it when it is translated into English but apparently in the works of Hayek and Von Mises there is a footnote somewhere that says "except agriculture" because the greatest hypocrisy in American politics is all these free enterprisers -- you notice the President tried to cut subsidies for agriculture – horrors! – let's cut children's lunches instead. But we have this fear that if you do that, it's freedom that's at stake, not just economic efficiency.

Now the advocates of de-regulation have had pretty much their way for several decades in America – certainly with the advent of Ronald Reagan. I was standing at Ronald Reagan's first inaugural, my first year in Congress, when he said, "Government is not the answer to our problem. Government is the problem." He meant it quite literally.

And even Bill Clinton, while he didn't fully agree with that, felt he couldn't confront it head-on. In fact, my greatest disagreement with Bill Clinton was when he stood up at a State of the Union address the year after the Republicans took over Congress and said, "The era of big government is over." I asked some of his people, "When was that? Did I sleep through it? I mean when was the era of big government in America?" Maybe from 1933 to 1935?" Certainly nothing I ever remembered. Regulation was on the defensive.

As late as 2006, when the Democrats won the election and I was the chairman-in-waiting of the Financial Services Committee, I was besieged by people telling me that my job was to deregulate – that Sarbanes/Oxley and other regulations were driving all American business overseas. They were going to go to the United Kingdom, where the Financial Services Authority engaged in light touch regulation. The head of the Financial Services Authority just announced, in case you missed it, "The era of light touch regulation is over." It went the way of big government but it had more of a life before it died.

The deregulators had their way and the consequence is the disaster we now face. And they are fighting very hard to stop us from doing what Franklin Roosevelt did and from doing what Theodore Roosevelt and Woodrow Wilson did because it's a major ideological fight. Now they understand that things are in pretty bad shape. So they have an alternative explanation – that's what I referred to by blaming the victims for this in the title of this speech, which I only decided on belatedly so maybe you didn't know that was the title because it wasn't out in time for the remarks.

The argument on the right wing – people now agree that this problem came because more than anything else too many loans for housing were made to not very rich people who couldn't pay them back There's general agreement that that was the problem. What happened was, I think, another metaphor is to think of this as bullets and guns. Those were the bullets – the bad subprime loans. The guns then were these very sophisticated instruments, collateralized debt obligation derivatives, that rocketed them all throughout the world, but it began with those guns. So they acknowledged that it was subprime loans made to people who couldn't afford to pay them back that caused problem.

But their argument is that the people who made those loans – the government made them do it. It's the "Geraldine" theory – some of you will remember Flip Wilson. Flip Wilson was an African American comedian, very funny, back in the days of a little bit less political sensitivity and one of his favorite characters was an African American woman named Geraldine. And when confronted with a misdeed, Geraldine's answer was, "The devil made me do it." Well apparently the devil made them make all these bad loans – the devil being the government in this right-wing cosmology. And the argument is that it was the attempt by liberals to help poor people that made them make all these bad loans and that's what caused the problem. And that's been a powerful enough argument and because I am one of the leaders in trying to put in the regulation, I get some of the blame for this, I have been the target of a great deal of this.

In this respect, I did have one regret – my mother, some of you knew, was a wonderful fighter for elderly rights – she passed away a few years ago, and you always miss a parent, but I particularly regretted that she wasn't around to hear Dick Cheney single me out for attack. To use a technical, parliamentary term, my mother would have kvelled to hear Dick Cheney attack me, kvell being the Yiddish word for taking particular pride in someone.

But the argument is that we liberals try to help the poor people. One of the things they want to blame is something called the Community Reinvestment Act. Let me make just make one easy statement here. The Community Reinvestment Act, passed in 1977, led by Bill Proxmire, said that if you are a bank and take deposits in a particular area, you've got to put some of those deposits back into the area. That's about all it says – it's fairly vague. It applies only to banks – only to technical banks – institutions that take deposit funds and are regulated. If only banks made mortgage loans, there would be no crisis. Overwhelmingly the loans that were made that caused the problem were the loans that were made by the non-banks. So blaming this is nonsensical. To their credit, every single regulator of banking in the Bush administration and the Federal Reserve, the Comptroller of the Currency, the FDIC has said “Nonsense, it’s not true.” But that’s part of their argument.

The other one is, and here’s where I come into the act, well we pushed Fannie Mae and Freddie Mac, the two secondary mortgage entities, to do this. Well the first thing to remember is that Fannie Mae and Freddie Mac never made a loan. They bought loans that other people made. So they could hardly have been the original source.

As to pushing them, here is the problem. And we’ve had this dispute and it’s part of it --Nick Retsinas is here and I’ll call on Nick for support later. Yes, there’s been a dispute between liberals and conservatives over housing and we have pushed for housing for the poor over their objections – rental housing. What’s been too little understood is that it was on the whole the conservatives’ philosophy that denigrated rental housing. When the Republicans took power in 1995, they systematically dismantled virtually all of the programs that had been created to help build rental housing for low income people. Their replacement was to help poor people become homeowners.

I had a debate with Alfonso Jackson, who had been Secretary of HUD in the Bush administration, in which he told me he wanted to take the Section 8 program, which is rental assistance for poor people, and say that after five years in that program you couldn’t get rental assistance anymore. And he said, “Do you agree with that?” And I said, “Well I would with one condition. I would agree that people should lose their rental assistance after five years if you would agree that they wouldn’t be poor after five years, because then they wouldn’t need it.” And he said, “Oh no, no, listen, be serious. Why are you opposed to it?” And I said, “Mr. Secretary, if you cut off people’s rental assistance after five years, what will happen to them?” “We will make them homeowners,” he said.

And yes in 2003 I was quoted as saying I didn’t think Fannie Mae and Freddie Mac faced a crisis. I didn’t think Wachovia did then either, or Merrill Lynch or Bear Stearns or a number of other institutions. What happened was in 2004 the Bush administration stepped up its effort to get low income people into homeownership. There’s a great book by Mark Zandi on the fiscal crisis that documents this. At that point it did become clear we had to do some regulation. So yes, it is true that there was a need to react, but it was because the conservatives killed rental housing, pushed people into homeownership and rejected Democratic efforts to regulate.

Now I know this is partisan, and let me tell you, yes it is partisan. First place, I am stunned at the notion that partisan is somehow inherently a bad word. I don’t think there’s ever been a democratic polity in the history of the world of any size where you didn’t get political parties. Not because somebody decided to do it but because you need some sort of organization. I mean partisanship could be excessive, but especially today the differences between the Democratic and Republican parties on virtually every important issue are quite sharp. There is a real ideological difference. And my one difference with our President, whom I admire enormously, having experienced these people, is when he said during the campaign that he thought he was going to bring in an era of post-partisanship. I understood how deeply right-wing these Republicans were and I told one of his staff that when he talked about being post-partisan, he gave me post-partisan depression. And you saw it – he tried and he was rebuffed, because they weren’t interested in this.

At any rate, that was the divide. And let me show you the partisan issue. In 1994, the Democrats were in control and passed a bill called the Homeowners Equity Protection Act, which told the Federal Reserve to regulate the granting of all mortgages in the subprime area because at that point it was clear that some of them were being issued outside the banking system. And Alan Greenspan, as he's now acknowledged was a mistake, explicitly refused to use the authority. You can lead a Federal Reserve Chairman to authority but you cannot make him use it, and he refused to use it, and so bad loans were made. That was 1994.

During our twelve years when we were in the minority, we tried to get legislation passed to say, ok if you won't do it, make it a law. And the Republicans stopped us. In 2007, the first year the Democrats were back in power, we did go back to it and the committee I chair passed a bill in the House and the Chairman of the Federal Reserve did it.

By the way, as to who's responsible for the subprime crisis ideologically, when the House passed the bill that I sponsored to stop people from getting loans if they couldn't pay them back, the *Wall Street Journal* editorially attacked us and said we were creating a Sarbanes/Oxley for housing and what about all these poor people who weren't going to be able to buy homes. The answer was it's the best thing we could have done for them.

And we will be following it up – we will be bringing a bill out in April from our committee that will stop people from getting loans in the future that they cannot repay. And someone said, "Oh, by the time you're through, the only home loans will be thirty-year loans from banks." We said, "yes, what was the criticism again?" Because that's what used to work.

But at any rate, the claim is false and I do have to say, 'cause we're in a big debate here, the Republicans controlled the Congress from 1995 to 2006 and passed zero legislation to regulate Fannie Mae or Freddie Mac, to restrict subprime loans or to do so anything else. We are in the process of doing it.

So now our view is, why did people make those bad loans? Because they could. That's the free enterprise system. That doesn't make them bad people. In the free enterprise system, you are supposed to make as much profit as you can without violating the law. There were some law violations, and there were some abuses. But if we want to restrain activity, you don't preach—you pass laws. Because by the way, if you want to restrain activity by preaching, then some people will and some people won't. There's a competitive drive out there.

You know, the way in which -- there's a very brave man named Harry Marcopolis, who was the first one to blow the whistle on Bernie Madoff and actually we were very flattered because he came to Jim Segel, who's sitting here and who works for me, and said he trusted us to hear the story. He got onto the Madoff thing because he was working for a competitive company and the company said to him, "Will you please go find out how the hell he does that, because we want to do it too." And he came back and said, "I know, he makes it up."

But that's an example of what's going on – the competitive pressures. If you don't have rules, then Gresham's Law will work and the bad will put pressure on the good. And so if you want to…you know people will say "well how come you aren't making more money?" I asked Charles Prince, when he was then the CEO for Citicorp, why he was not putting these structured investment vehicles on his balance sheet and he said, because if I do, I'll be at a competitive disadvantage vis a vis Goldman Sachs. So you've got to have the rules to make it work.

So here's what we plan to do: (and then I'm going to open this up) Our view is that it was the securitization process, particularly in mortgages but not only there-- in credit cards, in auto loans, in other loans – and the sophisticated way of rattling them through the system, including credit default swaps – credit default swaps deserve a little attention. They are a wonderful innovation. They are insurance that's not called insurance. You buy homeowner's, or automobile or life insurance and a state regulator makes that company show that it's got the money to pay you off with some combination of reserves and reinsurance. Credit default swaps were insurance issues without any reserve whatsoever. The reason is the people issuing them thought they would never have to pay off because they were issuing them on mortgages and they thought house prices would go up and up and up.

And so you say, well why would people issue all these insurance policies – credit default swaps – insuring other people against a drop in the value of their assets, when they didn't have the money to pay for it? It's very simple. Take the analogy of life insurance. They thought they were in the business of selling life insurance on vampires. I mean, you could sell life insurance on vampires without worrying. And then the vampires started to die. And that's the problem we've got. And what happens is bad loans are made and then they are sent through the system in an unsophisticated way because there are no regulations.

There are four things we want to do. First, I believe it is important that we say you cannot securitize one hundred percent of anything – that you have to retain some percentage of that—because it turns out – our mothers were right – people are not as careful with anybody else's money as they are with their own. And once enough bad loans are made, there is no way to recover. We thought, oh well don't worry about it. We have these ways of checking. For instance we had quantitative models. Nobody knew what the hell they were – literally -- they sounded good though. We had diversification. Yeah, but if enough bad things are there, diversifying just spreads the poison.

Then we had a great thing --the rating agencies. The rating agencies were going to protect you from buying bad stuff. So first the rating agencies gave ridiculously high ratings to garbage. Now because they are worried about it, they are underrating things. The State of California just went to the market -- we're working on trying to help them. They pay you six percent on full faith and credit bonds. Let me give you a stock tip. Go buy California bonds. There is no chance that the State of California will default – none whatever and you get six percent. And if you live in California you get it tax-free. But that's because the rating agencies, having overrated, now are now trying to cover themselves by underrating.

And they remind me of a great line by one of the great editorial writers of our time, Murray Kempton, with the old *New York Post*. He said, "Oh yes, I'm an editorial writer. Our function is to come down from the hills after the battle is over and shoot the wounded." That's what the rating agencies have effectively done. If enough bad loans are made ab initio there is no way to prevent it from poisoning the system.

So we start with restricting securitization – not to the point where it stops. And you know Roosevelt and Wilson didn't cut off large enterprises with antitrust laws and

FDR didn't shut down the stock market with the SEC. And we can adopt some restriction on a hundred percent securitization that will allow us to continue to get the benefits.

Secondly, we have to deal with the incentives of compensation. The problem with the large compensation of chief executives is not simply the amounts -- it is more that they are perverse incentives in their structure. Essentially they are this: If you are in charge of the company and you take a big risk and it pays off, you make money. And if you take a big risk and it costs the company money, you break even. It's heads they win, tails they break even. If you have a situation where if you take a risk and it pays off, you win and if it fails, you break even, you will take much too much risk. We had a survey done by, actually one of the rating agencies, I'll give them credit on this one, that showed that there was a high correlation between companies that paid their chief executives or top decision-makers in incentives and then had subsequently to redo their finances because people would play with the books to do this. So we're going to say that bonus incentives have defied gravity. They're the one thing that would go up without coming down. It's got to be a two-way street. If you want to pay your decision-makers with rewards for risk-taking, then they have to be penalized if the risks cost you money.

Third, we need to have a way, and this is very important, to wind-down institutions. Wachovia Bank failed and it was sad, but it was not a cataclysm. But when Lehman Brothers and AIG were in failure they became cataclysms because we do not have statutory mechanisms using the constitutional powers of the bankruptcy code to let someone step in and do them in an orderly way. So in Lehman Brothers they paid nobody and in AIG they paid everybody and they have been equally disruptive to the system. So that's a third thing – it's called resolving authority -- very euphemistic but somebody needs to be able to wind those down.

And finally, and most importantly, some combination of entities in the federal government have to be in charge of systemic risk. Now this will not undercut the current requirements that people regulate institutions to make sure they are safe and sound individually. Indeed we will be talking – I talked to Elizabeth Warren from Harvard Law School just recently, about the importance of beefing-up the investor/consumer protection parts of what we do. And you know, we used to think – by the way, this is where we were three years ago when I came in – what about hedge funds? Oh, don't worry about hedge funds – here's our protection. We only allow people to invest in hedge funds if they have a million dollars to invest. Well, people with hundreds of millions of dollars got badly burned in auction rate securities, and swaptions and other sophisticated "doohickeys" that blew up in their faces. So we need to give more protection there. But over and above all of that, no institution anywhere in the financial system ought to be able to get so indebted that it threatens our stability. We are talking about someone being able to step in and say, "Sorry, you cannot do this. You're going to have to have more capital and less leverage." Now exactly how you do that, we have to work on. But those are the two alternatives.

The conservative view is stop trying to help poor people. That's it. Repeal the Community Reinvestment Act. Our view is no, let's try to help poor people. Let's have regulations in that distinguish between good and bad ways and let's put into place a series of regulations that would be comparable in impact and scope to what FDR did and to what Theodore Roosevelt and Woodrow Wilson did. And it's a very intimidating prospect but I do believe that the result, if we do this right, will be what the result was in 1910 and in 1935 – a financial system that works better, that gives us the full benefit of the vigorous private sector mechanisms and diminishes abuses of the kind we have had. We didn't have another Great Depression because we reacted to the Great Depression with Federal Deposit Insurance and the Securities and Exchange Commission and the Investment Company Act. We've kind run out of the ability to rely wholly on that set of rules. We now need a new set of rules so nobody's going to have to go through twenty and thirty years from now what we're going through now.

Thank you.