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"Restoring the Economy: Strategies for Short-term and Long-term Change"

Thank you Chairman Maloney, Vice Chairman Schumer, ranking members Brady and Brownback, and members of the committee, for the opportunity to testify today. I am pleased to appear before you to discuss “Restoring the Economy: Strategies for Short-term and Long-term Change.” I am Joseph Mason, Herman Moyse, Jr./Louisiana Bankers Association Professor of Finance at Louisiana State University and Senior Fellow at The Wharton School, and these are my personal views.

The Committee has asked panelists to opine on both short- and long-term changes that can help restore the economy. The written testimony that follows outlines three primary suggestions in each regard, focusing primarily, but not exclusively, on financial market reforms. The reason for that focus lies in the macroeconomic understanding that financial crises do not cause recessions, but prolong and/or deepen them. Recessions are therefore possible *without* a financial crisis, but once an economy is in recession recovery is virtually impossible *with* a financial crisis. Until the crisis is resolved, therefore, fiscal and monetary policy merely push on a string.

In the short-term, resolving the crisis will require humility and hard work. The United States still has the most advanced financial system in the world, but the crisis resulted because the system got too far in front of regulatory capabilities. Among the key weaknesses that caused the crisis are classic problems like banks that consider themselves too-big-to-fail, insufficient accounting transparency to support regulatory and investment needs, and textbook asset market overhang in housing markets. Luckily, those problems are relatively easy to resolve in the short run, even if doing so will take courage and flexibility. While existing policy attempts to address some of these issues get close to helping, slight changes in approach can achieve success in a much more straightforward and effective manner.

The long run will be much harder, requiring significant efforts to fix old and build new regulatory structures and set the stage for U.S. economic growth. Much of the work will not be glamorous. Before one brick can be laid in the new financial structure, there needs to be a discussion of regulatory principals that will serve as the mortar of the construct. Much additional work will lie with international bodies, wherein I expect participants will build upon existing unitary principals of oversight laid down nearly two decades ago to develop standards and procedures for resolving failed financial institutions, providing bridge financing and oversight, and disposing of their assets. Global imbalances in economic growth potential are already spurring the development of trade blocs and agreements worldwide, presenting both opportunities and threats to U.S. markets. U.S. diplomacy abroad will go a long way toward smoothing some of those sentiments, and regulatory changes at home can help U.S. businesses adapt strategically to fast-moving changes in global markets and stay competitive.

Out of every crisis, it must be recognized, arises an opportunity to improve. The objective at the end of the exercise – which may be twenty years away – therefore, must always be kept in sight: set a firm foundation for improved financial markets and economic growth potential so that the necessary restructuring becomes known more *for its own success* than the crisis that spurred us to action.

I. Restoring the Economy in the Short-run: Resolving the Financial Crisis

As mentioned above, the key problems of the current credit crisis are banks that consider themselves too-big-to-fail, insufficient accounting transparency to support regulatory and investment needs, and textbook asset market overhang in housing markets.

A. End Too-big-to-fail

The too-big-to-fail doctrine has been around for some twenty years now and has yet to be resolved. The latest incarnation has been justified by "systemic" importance of some institutions over others. **Systemic importance, however, is a specious and potentially disingenuous concept.** There is no accepted definition of systemic risk, save that which points to a fundamentally unquantifiable transmission of risk through the financial system, akin to contagion.

Unlike contagion, however, there need not be a non-fundamental mechanism at work in systemic risk – merely one that is left unmonitored so that it passes risk to the entire financial system. Hence, to an aggressive systemic risk regulator, everything is likely to look like systemic risk. Moreover, markets with systemic risk protection will find little need to monitor counterparty exposures, creating severe moral hazard conditions. (See, for instance, Peter J. Wallison, "Casting the Fed as a Systemic Risk Regulator," AEI Financial Services Outlook, February 24, 2009).

Indeed, **the "systemic" nature of today's problems lies only in the degree to which large banks managed to enter business arrangements that themselves and regulators were reluctant to monitor.** Today, there are two big impediments to placing insolvent banks in receivership, thereby prompting claims of too-big-to-fail. First, regulators would have to acknowledge that they did not understand the extent or importance of bank off-balance sheet commitments. Regulators expressly allowed contracts to be written that are triggered by receivership, but now does not know which and how many or who will gain and, especially, who will lose if the institutions fails. In reality, the situation may be more similar to that of Continental Illinois in 1984, when the OCC said it feared spillover that would cause many banks

to fail – a fear that was later revealed to be grossly exaggerated. Regulators today do not have the necessary information not because it is impossible to obtain, but because they have not heretofore sought such information, reasoning that off-balance sheet arrangements did not matter. Future crises are therefore probably not best avoided by allowing a systemic risk regulator to stand ready to make excuses for regulatory laxity.

Second, and equally important, regulators today have not yet managed to transfer servicing rights successfully out of a failed institution. Mortgage bank failures in the late 1990s followed an almost identical path to the larger-scale disruptions we are seeing today. Failure typically occurred at the end of a chain of events wherein subprime mortgage providers lowered underwriting standards to fuel growth. The resulting diminished loan quality, however, hurt their securitizations and resulted in financial losses in both on- and off-balance sheet arrangements. Struggling to survive without securitization, firms flooded the whole loan sale market, causing precipitous declines in whole loan prices. Stock prices of subprime lenders plummeted and highly leveraged companies could not repay debt. Without funding sources other than securitization, financially stressed issuers had no alternative but to file Chapter 11. By the end of the decade, few subprime originators remained. (Moody's, "Bullet Proof Structures Revisited: Bankruptcies and a Market Hangover Test Securitizations' Mettle," 20020830 at 12.)

Both off-balance sheet risks and servicing rights transfer difficulties are known-unknowns, known by the industry but "unknown" by regulators. **Merely ignoring risk does not make it systemic once the denial becomes evident.**

Today we all know a great deal more about bank operations and values than we did previously. Even without resorting to custom-designed stress tests (which cannot be developed to deliver any useful degree of accuracy in a matter of weeks, but take years to parameterize), we

know that there are three classes of banks in the system right now: the insolvent; the marginally solvent; and the solvent. **Policy needs to focus on relieving the economy of the value-destroying loans produced by the now-insolvent banks, financially and operationally restructuring the marginally solvent banks, and building economic growth upon the lending platforms of value-creating solvent banks.**

Insolvent banks – regardless of their purported systemic importance – are value destroying institutions that need to be closed. If insolvent banks were car companies, they would be relying on worn machinery and ill-trained staff to produce East-German Trabants that break down as soon as they leave the production line. In fact, the loan products these banks created did break down almost immediately after they were produced, in that they exhibited early-payment defaults and often involved payments and fees that the borrower could not afford. The mortgage delinquencies we see today are therefore the result of faulty management, bad supervisory systems, ineffective proprietary software, and ill-targeted employee training, not mere exogenous economic shocks, and the banks that produced those products are insolvent as a result. **Insolvent institutions therefore need to be shut down in the public interest: while the economy needs loans to fuel economic growth it needs high-quality *value-creating loans* that borrowers stand a chance of repaying, not *value-destroying* loans that disrupt economic activity even further.**

Marginally solvent banks face difficulties, but maintain some redeeming assets that suggest they possess going concern values worthy of being maintained. That is, the majority of marginal bank portfolios consist of value-creating loans that benefit economic growth. **Government recapitalization programs with appropriate limits on management and insistence on institutional reforms can, therefore, benefit marginally solvent institutions**

and present a *possibility* of supporting economic growth by creating, rather than destroying, value.

Solvent institutions need neither government assistance nor intervention, but can still utilize government funds to finance the purchase of failed-bank assets to relieve asset market overhang, which is discussed in further detail below. **To deny solvent institutions additional capital to address the economic situation is to penalize them for creating economically value-creating assets.** Policy needs to focus, therefore, on relieving the economy of the value-destroying loans produced by the now-insolvent banks, restructuring the marginally solvent banks, and building upon the existing value creating business platforms of solvent banks to foster sound economic growth.

In summary, it is crucial to dismantle the too-big-to-fail doctrine for the good of the American banking system. No firm is ever too-big-to-fail. While some firms may be too misunderstood for regulators to effectively manage the failure and subsequent disposition of assets, the misunderstanding is fundamentally different from too-big-to-fail and not an excuse worth of justifying a lasting or fundamentally irreconcilable systemic risk exemption. Hence, other short-term policies address transparency so that the firms can be better understood and flexible means of asset disposition policy that have been heretofore overlooked.

B. Increase Investor and Regulatory Transparency

The key problem with financial markets right now is that commonly-produced standardized financial ratios are meaningless. Without information, investors do not know the value of their holdings, cannot sell those holdings, and cannot rationally allocate funds derived from those sales if they could.[1] Without funds, firms cannot invest in new projects that create

[1] …and with interest rates near zero have no incentive to look very far for opportunities to sell, anyway.

economic value – that is, jobs, income, and economic growth. Nonetheless, existing policy proposals have all been about *suppressing* information: information about bank conditions, about other sources of risk, and even about government programs meant to address the situation.

Unfortunately, financial reporting is thought of as an excruciatingly boring policy topic.[2] More unfortunately, however, financial reporting is crucial to any well-functioning financial system. Without restoring financial reporting, we cannot hope to end too-big-to-fail (nay, too-misunderstood-to-fail) and we cannot expect to reinvigorate investment and economic growth.

The breakdown of financial reporting began with **off-balance sheet regulatory arbitrages** affected in the early 1990s in response to Basel I.[3] As bank conditions began to be evaluated on the basis of a capital/asset ratio on the tail end of a recession, banks seeking to raise their capital/asset ratio faced with the dilemma of whether to raise capital or reduce assets at a time when capital was prohibitively expensive. Hence, most sought instead to reduce assets through securitization.

Often, however, the lion's share of risk was not transferred in the securitization. Rather, sellers retained first-loss residual and mezzanine interests in the loans and offered further representations and warranties supporting the sale. Some of those representations and warranties were explicit, some implicit. Implicit representations and warranties are now referred to by the industry as "reputational risk," which has been cited as the reason some sellers repurchased entire deals of SIVs and ARSs, as well as other investments, in the past year.

As discussed in my Senate Banking, Housing, and Urban Affairs Committee (Subcommittee on Securities, Insurance, and Investment) testimony from September 18, 2008, as

[2] Only the chair and ranking member attended Senate Banking, Housing, and Urban Affairs Committee, Subcommittee on Securities, Insurance, and Investment hearings on FASB reform on September 18, 2008.
[3] Some also note the use of securitization to avoid interest rate risk in the 1980s. While that purpose was certainly useful, securitization did not really take off until the regulatory arbitrage became valuable.

early as 1987, Moody's pointed out that, "…the practices developed by the accounting and regulatory world … do not fully capture the true economic risks of a securitized asset sale to the originator's credit quality." (Moody's Investors Service, "Asset Securitization and Corporate Financial Health," December 1987, p. 3) Hence, long ago market insiders fully realized that standard accounting rules do not apply to securitizing firms.

In 1997, Moody's Investors Service wrote that, "…the simple act of securitizing assets can affect the appearance of the income statement and balance sheet in a profound manner without, in many cases, significantly altering the underlying economics of the [seller]." (Alternative Financial Ratios for the Effects of Securitization, Moody's Investors Service, September 1997, p. 1) With securitization, therefore, reported earnings are overstated and reported balance sheet leverage is understated while there may be little, if any, risk transference.

Moreover, it became common over time for sellers to voluntarily provide informal support to preserve the performance and bond ratings of their structured transactions. (Moody's Investor's Service, "The Costs and Benefits of Supporting "Troubled" Asset-Backed Securities: Has the Balance Shifted?" January 1997) As the practice became accepted by regulators and the marketplace, **ratings agencies could indeed rate any of these bonds AAA without reference to fundamental loan pool characteristics or securitization structure** because any seller with going concern value would support the pool to maintain its "reputational risk" so it could issue again next period. Of course, it would be egregious to maintain that securitization transfers no risk at all. As we have seen recently, in the event of catastrophic asset quality problems the seller may choose NOT to support a troubled deal, notwithstanding even any legal – much less reputational – responsibility to do so. That is why investors right now want to know how much more is out there in off-balance sheet exposure that can still threaten the firm's ability to

"reputationally" support their securities. Unfortunately, those answers are not easily found, even for professional investment analysts.

Those off-balance sheet arrangements were also the first to utilize **mark-to-market** (really, mark-to-model) accounting features under the guise of gain-on-sale accounting. Gain-on-sale accounting led to tremendous industry disruptions in the late 1990s. FASB'S August 11, 2005, Revision of Exposure Draft Issued June 10, 2003, "Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140," (Financial Accounting Series No. 1225-001), explains gain-on-sale roughly as follows: In order to facilitate "gain-on-sale accounting," the firm (1) estimates the value of the thing they want to sell with a financial model. Then, the firm (2) receives some money and other items in the actual sale of that thing. Next, in what is the really arbitrary aspect of gain-on-sale accounting, the firm gets to (3) record the difference between their own valuation of the thing that they sold and the value of the cash and other items received in the sale as cash revenue.

Difficulties in the high-LTV home-equity loan crisis of the late 1990s were largely attributable to aggressive gain-on-sale accounting. According to Moody's:

> *In the late 1990's, several subprime home equity and auto lenders encountered financial difficulty arising in part from explosive growth patterns, in part from using securitization as a source of funds, and in part from overly aggressive use of gain on sale accounting. Such accounting methodology made these companies look much stronger financially on paper than they actually were. Companies that used gain on sale accounting included, among subprime mortgage issuers, Contifinancial Corp., Southern Pacific Funding Corp., Cityscape, and United Companies Financial Corp.… Once the effect of gain on sale accounting was removed from financial statements, leverage ratios were often high.*

> *These companies also had weak capital positions compared to more diversified finance companies.* (Moody's Investors Service, "Bullet Proof Structures Revisited: Bankruptcies and a Market Hangover Test Securitizations' Mettle, August 30, 2002, p. 14)

The problem with gain-on-sale accounting, therefore, is that the revenue booked is not real cash. Hence, many recently-failed mortgage companies and similar firms associated with previous securitization fiascos have *never been cash-flow positive in their entire corporate lives*. When firms, realizing the risks of gain-on-sale accounting and the false earnings conditions they represented to investors, sought to pull back from gain-on-sale and become more conservative, they were told by FASB that any willing conservatism would be considered earnings manipulation. Thus, the financial world was recently littered with hundreds of firms with exceedingly high stock values that had never actually earned positive cash profits in a manner typical of a classic bubble.

Both off-balance sheet exposures and mark-to-market accounting argue for a more robust financial reporting environment than is that envisaged by the Financial Accounting Standards Board (FASB). In the Senate Banking, Housing, and Urban Affairs Committee, Subcommittee on Securities, Insurance, and Investment hearings on FASB reform on September 18, 2008, FASB abjectly refused to even consider advocating any deviation from an accounting system based on a *single* value for any particular item or firm. But in an off-balance sheet world of contingent claims and statistically modeled values for level 2 and 3 "mark-to-market" assets, a single value is not only inadequate, it is grossly misleading.

Investors want to know the *entirety* of off-balance sheet exposures right now – knowing that the commercial banking industry is leveraged not at the 12:1 reported on balance sheet, but at roughly 185:1 off balance sheet – but are not able to get the information from existing

sources.[4] That does not mean that FASB should reverse policy and disallow off-balance sheet treatment, putting off-balance sheet exposures completely back on-balance sheet, only that the off-balance sheet exposures need to be completely and systematically reported somewhere in the financial statements.

But investors also want more. Investors also want to know the *range* of statistical model values that can be reasonably expected to apply to level 2 and 3 assets – that is, the standard errors of the estimates. Such ranges will allow investors to "stress test" firm financial characteristics *on their own*, in a clearly transparent way without being filtered through Treasury's secrecy and interpretation.

It is important to realize that the investors I have been talking about include all bank "counterparties." Outside investors today can evaluate banks no better than banks can evaluate one another's **counterparty risk.** Hence, transactions have shut down in today's opaque financial reporting environment. Guarantees and other second-best solutions will only alleviate counterparty risk concerns as long as the guarantor (even the Federal government) remains willing, credible, and solvent. Hence, the key objective has to be to restore financial market transparency as soon as humanly possible so that markets can once again work without the aid of outside guarantees.

C. Deal with Asset Market Overhang

The above discussion of financial reporting suggests that even if financial market prices are well-established, they are not presently communicated through credible financial reporting mechanisms. In today's housing markets, however, values of foreclosed and vacant houses are

[4] Even SEC Regulation AB was arbitraged when banks hid the required information on the internet. Try working with the following link (not linked to any of Countryside's corporate web site and with no main page to change reporting periods or otherwise run scenarios an investor might be interested in) for some of the data behind Countrywide's deals: http://www.countrywidedealsdata.com/RegABDealList.aspx?CWDD=01200804 .

far from certain. Hence, alleviating the stock of unsold and unoccupied homes in today's housing market should be a key concern. Unfortunately, dogmatic "home ownership" policy and archaic bank regulations stand in the way of quick recovery. If we **view the housing crisis as merely one of occupancy** rather than ownership, policy solutions are readily at hand.

The common understanding of the problem is that foreclosed homes are dumped on the market at fire sale prices and those prices push values down in surrounding neighborhoods.[5] But while focusing on the foreclosure part of the problem we are missing the important part: the fire sale that pushes down prices. Fire sale prices result not because lenders want to sell at a loss, but because lenders – usually commercial banks – are prohibited from managing the real estate except for the brief period of time during which it is on the market for sale.

Consider what would happen if the bank could rent the home out and wait for market recovery. The bank would replace the cash flow from the loan with a slightly lower cash flow from rental income. While the bank would still book losses from legal costs and a lower rental income cash flow, fire sale losses could be avoided. Lastly, the bank can sell the home in the market upturn several years hence and possibly recoup some of the losses in the failed loan.[6]

Consider the additional social advantages if the bank could rent the home *to the existing occupants*. If the financial conditions of the renter improved with economic recovery, the bank may also have a ready buyer in the existing occupant, as well. Occupants would have more of an incentive to maintain the property and foreclosed owners would have less incentive to destroy the property in reaction to bank actions. Occupants would most likely buy the house back from

[5] Although I do not need to go into it here, the common understanding is flawed: a foreclosed home is often of lower value than an occupied home because it has deteriorated in condition due to lack of maintenance and sometimes willful destruction of the previous occupants.
[6] Bank ownership could be limited to seven years to ensure that banks do not end up being primarily real estate development companies.

the bank at a market-determined value later on, relieving the need for government guess work in the middle of a crisis.

Such regulatory changes are a simple way to **ensure that home owners affected by the crisis do not get hurt *again***, something current modification proposals do not adequately address. In fact, forthcoming research shows that many companies claiming to be special servicers – but really run by the same managers that owned failed subprime mortgage companies – are already entering the business to fleece borrowers and collect the $1,000 per head fee offered under the most recent housing plan. Even worse, modification frauds have proliferated throughout the country, preying on the same uninformed consumer that got the unaffordable subprime loan.

The fact is servicer quality matters, and servicer quality matters even *more* when loans become distressed. A defaulted borrower that re-establishes payment on their loan usually does so because of some element of trust between them and the servicer that leads to establishing a payment plan the borrower believes is advantageous to both parties. The servicer may work on the borrower's behalf as part of that plan, assembling a program combining elements of bankruptcy, selling other assets, or consolidating other loans. If the borrower is still unable to make the payments, the servicer maintains a good relationship with the borrower through the foreclosure process to preserve the value of the home and liquidating the collateral to collect money owed to the investor. (Fitch, "Scratch & Dent: This Is Not Your Father's MBS," 20051213 at 8)

But the servicing industry already has a checkered past. In the 1990s subprime mortgage servicers were plagued with problems: aggressive growth strategies led to expanded underwriting guidelines; a significant increase in correspondent lending led to inflated property

appraisals; and predatory practices both in underwriting and servicing led to rampant lawsuits. Many of the players that were market leaders – such as ContiMortgage, IMC Mortgage, United Companies, and The Money Store – went out of business long ago. (Fitch, "Rating U.S. Residential Subprime Mortgage Securities," at 1)

According to Elizabeth McCaul, former Superintendant of Banks for the State of New York, some areas of weakness in the servicing industry in recent years leading up the present crisis included "…a lack of focus on the strength of the originator/servicer, and improper analysis of the substitution of good loans for bad. We have seen re-aging policies not being properly analyzed. In fact, investment in this area has been largely driven by mathematical formulations without enough qualitative analysis of operations and financial strength. For example, we have conducted reviews of portfolios and seen residuals on balance sheets that do not reflect enough financial strength to continue operations effectively. If the shop is closed, the Trustee comes in, the re-aging practices (and other practices) are halted… delinquencies roll in, and the rest, as you know, is history." (McCaul, Elizabeth, "What's Ahead for the US Residential Mortgage Market," Speech at ASF 2007 conference by Elizabeth McCaul of Promontory Capital, former Superintendent of Banks for the State of New York, February 2, 2007 at www.SIFMA.org)

According to Bank of America, "Payment deferral will not help people who inflated incomes or recklessly bought properties they could not afford (by some estimates, 70% of stated income loans contain inflated by 50% or more)." (Bank of America, "Subprime Mortgage Finance Weekly: Subprime Loan Modifications – not a Panacea," May 25, 2007, p. 4.) Deferring payments for such borrowers may just squeeze the last pennies out of the borrowers' pockets. If the borrower has no true hope of owing the home, even with the deferment plan, the program

may be judged to be predatory. Even if such remedies are targeted across the pool of borrowers evenly, if protected class members adversely select to participate in such programs the outcome could be judged to harbor disparate impact. Worse yet, if the borrower does not maintain the house or destroys the house knowing that they cannot truly afford the home, the ultimate loss in foreclosure is larger than if the lender had foregone the mitigation. (Mason, Joseph R., Mortgage Loan Modification: Promises and Pitfalls, October 3, 2007. Available at SSRN: http://ssrn.com/abstract=1027470) Hence, according to Moody's, modifications that are used properly are obviously a very good tool. But, "…the one thing you don't want to do is to defer the inevitable."

The investor (and borrower) is therefore at the mercy of the servicer who is making a "…judgment call as to whether a mortgage is salvageable or not, and that varies depending on market conditions," as well as personal conditions of the borrower and their intentions. (Moody's, "Sub-Prime Mortgages: An Integrated Look into Credit Issues Today and What to Expect," Transcript of a teleconference held on Friday, 9 March 2007 at 16; Mason, Joseph R., Mortgage Loan Modification: Promises and Pitfalls, October 3, 2007. Available at SSRN: http://ssrn.com/abstract=1027470)

Moreover, that judgment call is made with virtually no direct oversight. In most cases, prior to a servicer's default, the is trustee not required to investigate accuracy of information stated in any document it receives, unless it receives a written request from insurers or holders of minimum percentage of outstanding certificates to do so. Of course, a conundrum arises because insurers and investors have little reason to assume such a written request is necessary without some investigation of the accuracy of information in the documents. The point is the investor has to completely trust the servicer to act on their behalf, often in substantially unverifiable

dimensions. (Heller-Ehrman, "The Subprime Mortgage Crisis-Overview of Civil Litigation Claims," Presentation from Navigating the Credit Crisis Conference, Wednesday, March 5, 2008)

Even if the trustee were to undertake such an investigation, however, the standard of service required of the contractual arrangements is vaguely defined. Typical provisions require the servicer to follow accepted servicing practices and procedures as it would employ "in its good faith business judgment" and which are "normal and usual in its general mortgage servicing activities" and/or certain procedures that such servicer would employ for loans held for its own account. (Heller-Ehrman, "The Subprime Mortgage Crisis-Overview of Civil Litigation Claims," Presentation from Navigating the Credit Crisis Conference, Wednesday, March 5, 2008)

Servicing, therefore, is a crucial aspect of value to all consumer loan securitizations but it is not very well understood by regulators or investors. The problem is that servicer accountability and reporting to investors and regulators is woefully inadequate. Adequate information to evaluate servicer quality rarely exists, and where it does it is not consistently or widely distributed. Hence, regulators can do a great service to both the industry and borrowers in today's financial climate by insisting that servicers report adequate information to assess not only the success of major modification initiatives, but also overall performance. The increased investor dependence on third-party servicing that has accompanied securitization necessitates substantial improvements to investor reporting in order to support appropriate administration and, where helpful, modification of consumer loans in both the public and private interest.

II. Restoring the Economy in the Long-run: Building Tomorrow's Growth

While the key challenge to implementing the short-term elements above are primarily inflexible dogma and courage, the challenge to long-term elements will be that of staying

focused on the problems long after the crisis has passed. Nonetheless, fundamental changes to domestic and international regulatory structures will be key to maintaining U.S. financial market competitiveness, and policies that can streamline productivity gains through removing outmoded regulations and other impediments to growth can help increase U.S. economic competitiveness overall. Again, however, I cannot stress enough that focus will be the key. Hence, the short-and medium term need to be devoted to setting a foundation of shared bipartisan understanding of the issues the policies that need to be addressed. Only with a foundation of genuine shared understanding and agreement can the policy discussion last long enough –most likely this will take several political administrations – to reach meaningful solutions.

A. Lay Down a Firm Foundation for Domestic Regulatory Structures

Using the analogy of the "financial architecture," the primary foundation lies in the fact that even the best architects cannot expect to create buildings that plumbers, electricians, and carpenters cannot build. Certain physical limitations of the financial system need to be addressed on a mundane fundamental level before we can think about the form of the regulatory system that we expect to arise. Changing titles of key regulatory officials, in the manner of a typical corporate reorganization, will not lead to effective change. As James Aitken of UBS is fond of saying, "start with the plumbing." To that I would add that not only is the plumbing the hardest thing to change afterward, but flow is a natural concept that is impossible to fight and back-ups really stink!

The starting point is the basic concept of and appropriate role for financial regulation. **There will always be a portion of the financial system in which highly risky products are traded with freedom and there should always be a portion where risk is kept within certain well-monitored acceptable levels.** Hence, there will always exist a continuum of regulated and

unregulated institutions (whether we like it or not – black markets work, too). If we push regulation to hitherto unregulated institutions, new unregulated institutions will be developed to operate in the unregulated portion of the continuum. Hedge funds arose in this regard, and new institutions will develope behind them.

That starting point leads to the recognition that one key principal violated in the recent crisis is akin to the gravity that causes water to flow downhill: while it is fine for non-regulated financial institutions to invest and fund themselves via regulated institutions, if the system allows regulated institutions to fund themselves and invest in non-regulated products you have a recipe for disaster. **We should want risk to travel from regulated to non-regulated firms, but we should try to prevent risk from travelling the other direction.** When banks funded lending via private unregulated securitization markets, banks began to rely crucially on a set of unregulated financial institutions that was not fully developed and is therefore prone to volatility and upset – the recipe for the disaster we are seeing.

That leads to a second observation: risk never goes away. Pooling loans to serve as collateral for a securitization does not create diversification any more than buying more shares of the same firm. Tranching mortgage- or asset-backed securities also does not reduce risk, it only moves it to the most junior bond claimants – usually the banks, themselves, that hold the residuals and mezzanine stakes.

The point is that **in a world based on financial engineering, risk is increasingly fungible**. For instance, where risk seems to disappear on a *contractual* basis, it reappears on a *reputational* basis. It is straightforward, therefore, to propose that **reputational risk is valuable**. Moreover, however, reputational risk is fairly easily defined in terms of game theory: reputational risk exists when there is a cost of cooperating and that cooperation is necessary to

continue the game to the next period (i.e., bailing out securitized investors like those in SIVs and ARSs). It is straightforward to propose, therefore, that firms should hold capital to cover the probable cost of cooperation.

The starting point of acknowledging roles for risky and less risky institutions and the evolution of institutions to meet market needs also leads to an acknowledgement that financial innovation will always be with us. Hence, we **need a system flexible enough to monitor new developments** and relate their importance to the gravity and fungibility conditions discussed above. From 2001 through 2008, Mark Adelson (now at S&P) archived panel notes at structured finance industry conferences around the world that described how the industry has long been concerned with many of the issues that are causing the present crisis. (see http://www.adelsonandjacob.com/publications.html) Regulators, however, failed to listen to discussion within the industry, choosing instead to ignore the developments until the scale of difficulties rose to a national economic crisis that demanded their attention.

This failure to monitor financial innovation and new financial institutions – along with the specious nature of the currently proposed systemic risk regulatory approach – leads to consideration of a much more effective monitoring role for all regulatory agencies, tracking innovation and new financial institutions to ensure that they do not move unregulated risk into regulated institutions by transforming it into previously unmonitored forms.

Finance is a fast-evolving field. Financial regulators therefore need to be proactive in their approach, so that they are not "surprised" enough for unmonitored risks to become anything that could even loosely be considered "systemic" in the first place.

B. Start Building a More Comprehensive International Regulatory Structure

Currently, other dogmatic and inflexible approaches are driving a wedge between European and U.S. regulation, and both are leaving the rest of the world behind. Instead, it makes sense in an increasingly global world to work with other countries to further develop unified standards set under the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) that can deal not only with prudential supervision of banks in particular, but financial institutions and their failures more generally.

According to the Federal reserve Bank of New York, foreign banking institutions, which include foreign bank branches, agencies, and U.S.-chartered bank subsidiaries, hold approximately one-fourth of all commercial banking assets in the United States. In December 2006, foreign banking organizations operated or controlled 188 branches, 133 agencies, 62 U.S. commercial banks, and 8 Edge or Agreement corporations. Foreign banking institutions held about $216 billion in commercial and industrial loans, roughly 18 percent of the total in the United States.

FBSEA laid down responsibilities for prudential supervision of foreign banking institutions largely in response to the Bank of Credit and Commerce International (BCCI) scandal, in which it was found that no regulatory agency took responsibility for BCCI's prudential supervision. FBSEA laid down rules of assigning prudential supervision authority among different countries. FBSEA also stipulated that although branches may receive deposits of any size from foreigners, they may accept deposits only in excess of $100,000 (wholesale deposits) from U.S. citizens and residents.[7] Similar provisions exist across European countries, limiting domestic deposit insurance liabilities to foreign depositors.

[7] Furthermore, as a result of the FBSEA, deposits in any foreign bank branch established after December 19, 1991, are not covered by U.S. deposit insurance; deposit insurance is now offered only to U.S.-chartered depository

Unfortunately, FBSEA has remained frozen in time as the global financial system has changed. In fact, we have learned from the current crisis that while it is important to limit deposit insurance fund liability across borders, it is equally if not more important to deal with asset resolutions across borders. For instance, with some 18 percent of U.S. commercial and industrial loans, the failure of a foreign bank can have dire ramifications for U.S. businesses. Furthermore, in the event of a deposit insurance payout at the foreign bank, foreign deposit insurance authorities' dealings with U.S. borrowers could be important to U.S. regional or national economic performance. Even more complex, will foreign bank U.S. asset proceeds be used to pay amounts due to U.S. depositors, or do those satisfy foreign bank home country insured depositors first?

Resolving global financial crises in a global marketplace means coordinating regulatory approaches to sell banks and bank assets across borders. Hence, we **need to develop a Foreign *Financial Asset Resolution* Enhancement Act** to effectively deal with other countries' regulatory systems that manage both bank and non-bank assets and smooth regulatory frictions that can interfere with orderly resolutions of financial assets, worldwide. This initiative **becomes more crucial day by day, as too-big-to-fail becomes too-big-to-save when financial institutions become larger than not only their safety nets, but also their home country domestic economies.**

C. Increase U.S. Economic Competitiveness

All of the above initiatives ultimately increase U.S. economic competitiveness. Increased international diplomacy regarding foreign bank resolutions can also create ties that break through foreign nationalist pressures and nascent trade blocs that are developing as countries try to

institutions. Foreign agencies specialize in making commercial loans to finance international transactions, and they may accept only short-term deposits related to such transactions.

insulate themselves from the global crisis. Those diplomatic efforts will help to maintain trade patterns that foster U.S. manufacturing and therefore economic growth.

Smart regulation in the financial sector will reduce unnecessary impediments to growth in U.S. financial markets, maintaining U.S. preeminence as having the most transparent and efficient markets in the world. Undertaking a broad-based review of the U.S. financial reporting will reveal obvious avenues for improvement – such as changing bank regulatory call report classifications for brokered deposits and developing increasingly relevant consolidated bank holding company-level Y-9 reports of off-balance sheet risk – that will lead to more sensible regulatory rulemaking in the new financial marketplace.

Similar smart regulation in other areas like energy can balance resource needs with energy reserves so that we do not needlessly sacrifice economic growth for archaic laws and regulations. Outdated policies that prevent virtually all offshore oil drilling around the U.S., restrict implementation of clean diesel technology, and simultaneously ignore strategic and environmental considerations of purportedly green (but only with respect to carbon emissions) technology.

III. Summary and Conclusions

This written testimony offers three primary suggestions for short- and long-term strategies to restore the economy and fostering long-term growth. Again, my testimony focuses primarily, but not exclusively, on financial market reforms. The reason for that focus lies in the macroeconomic understanding that financial crises do not cause recessions, but merely prolong and deepen them. Recessions are therefore possible *without* a financial crisis, but once an economic is in recession recovery is virtually impossible *with* a financial crisis ongoing.

As stated above, in the short-term, resolving the crisis will require humility and hard work. The United States still has the most advanced financial system in the world, but over the last several decades the growth of that system outpaced U.S. regulatory capabilities. Among the key weaknesses that caused the crisis are relatively well-understood shortcomings like too-big-to-fail, insufficient accounting transparency, and asset market overhang. We already have several decades of economic research that we can use to resolve those problems in the short run, even if doing so will take courage and flexibility. Nonetheless, while existing policy attempts to address some of these issues get close, slight changes in approach can achieve success in a much more straightforward and effective manner.

For instance, the House introduced Bond Rating legislation as HR 6482 last summer, but that bill was not put to vote due to the financial market crises of the period. Such legislation will be crucially important to moving the industry forward. But even dogmatic shifts such as focusing on the far more obtainable goal of housing occupancy instead of home ownership can help get our economy moving quickly again with a lower probability of home buyers getting hurt again.

As stated above, reform in the long run will be much harder, requiring significant efforts to fix old and build new regulatory structures and set the stage for U.S. economic growth. Much of the work will not be glamorous. Before one brick can be laid in the new financial structure, there needs to be a hard discussion of regulatory principals that will serve as the mortar of the construct. Much additional work is necessary to develop international diplomatic relations around existing unitary principals of oversight to develop standards and procedures for resolving failed financial institutions, providing bridge financing and oversight and disposing of their assets. Global imbalances in economic growth potential are already spurring the development of trade blocs and agreements worldwide, presenting both opportunities and threats to U.S. markets.

U.S. financial diplomacy abroad will go a long way toward smoothing some of those sentiments, and U.S. businesses will have to adapt strategically to fast-moving changes in global markets to stay competitive.

The binding principals of any regulatory reform process – which is a large part of what we have at hand here – are "do no harm" and "leave the industry cleaner than when you arrived." Hence, we have before us both the opportunity and motivation to improve our economy and our nation. Let us embark on setting a firm foundation for improved financial markets and economic growth potential so that the necessary restructuring becomes known more for its own success than the crisis that motivated the changes.