



CONGRESS OF THE UNITED STATES

JOINT ECONOMIC COMMITTEE

CONGRESSMAN KEVIN BRADY

RANKING REPUBLICAN HOUSE MEMBER



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**STATEMENT OF
CONGRESSMAN KEVIN BRADY**

***Unregulated Markets:
How Regulatory Reform Will Shine a Light in the
Financial Sector***

I am pleased to join in welcoming today's witnesses.

Many policy mistakes contributed to the global financial crisis that began on August 9, 2007 and triggered a recession four months later. These include:

1. The Federal Reserve's overly accommodative monetary policy from 2002 to 2006;
2. International imbalances arising largely from China's exchange rate policy since 1998;
3. President Bill Clinton's initiative to increase home ownership among low-income families by "reduc[ing] down payment requirements and interest costs by making terms more flexible" and "increas[ing] the availability of alternative financing products" without sufficient consideration of the ability of low-income families to meet their non-traditional mortgage obligations and the continuation of this mistaken policy by President George W. Bush;
4. Abuse of the *Community Reinvestment Act* through the filing of frivolous objections to bank acquisitions and mergers by ACORN-affiliated groups to extort banks into making large numbers of risky sub-prime residential mortgage loans to low-income families; and
5. Inadequate supervision of the alternative financial system based on loan securitization and highly leveraged non-depository financial institutions, especially Fannie Mae and Freddie Mac.

Banks perform the economically valuable, but inherently risky functions of intermediation and liquidity transformation by accepting deposits payable on demand and making term loans to families and small businesses that cannot issue commercial paper and corporate bonds. Due to the nature of their activities, banks are subject to runs. Runs often become contagious and may trigger financial panics.

To minimize the risk of financial contagion while retaining the enormous economic benefits from intermediation and liquidity transformation, Congress mandated supervision, created the Federal Reserve in 1913 to serve as "lender of last resort," and established federal deposit insurance in 1933. By the fall of 2007, the alternative financial system, composed of Fannie Mae, Freddie Mac, independent investment banks, finance companies, hedge funds, and off-balance-sheet entities, had assets totaling \$12.7 trillion and was essentially performing intermediation and liquidity transformation functions similar to banks without any of the safeguards that Congress had established for banks.

Since the financial crisis began, a number of major banks and other financial institutions have failed, were acquired at “fire-sale” prices, were placed into conservatorships, or needed massive federal assistance to survive. These include AIG, Bank of America, Bear Stearns, Citigroup, Fannie Mae, Freddie Mac, Lehman Brothers, and Merrill Lynch.

What are the common threads to these failures or quasi-failures? First, these institutions made bad investment decisions. Second, these institutions were overly dependent on short-term liabilities, outside of insured deposits, to fund their investments. Consequently, these institutions suffered liquidity crises when their creditors became aware of the magnitude of the investment losses. These liquidity crises were essentially the modern version of bank runs, in which computer clicks replaced queues of depositors withdrawing their money. However, the underwriting of corporate securities and municipal revenue bonds, which Glass-Steagall had prohibited commercial banks to do, was not a significant factor in any of the failures or near-failures.

I have a number of questions for the panel:

1. What changes should be made to the risk-based capital standards for banks?
2. Should Congress require all U.S. banks to adopt the system of dynamic provisioning for loss reserves that proved so successful in maintaining the solvency of Spanish banks during the financial crisis?
3. Should liquidity standards be established for banks and other highly leveraged financial institutions?
4. Should all banks and other highly leveraged financial institutions be subject to simple limits on leverage in addition to any risk-based capital standards?
5. Shouldn't Fannie Mae and Freddie Mac be restructured and fully privatized? Shouldn't any housing subsidy functions that Fannie Mae and Freddie Mac now perform be transferred to the Federal Housing Administration and be placed transparently on the federal budget?
6. Should highly leveraged non-depository financial institutions have access to the Federal Reserve's discount window? And if so, under what circumstances?
7. How should financial derivatives be regulated? Are credit default swaps uniquely risky and do they need to be regulated differently than other financial derivatives?

Members of the panel, I look forward to hearing your testimony.

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