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Madam Chair and Members of the Committee, thank you for inviting me to testify before you this morning.

This is a historic and deeply challenging moment in the annals of finance and public policy. It is historic because the Western financial system is experiencing shocks which virtually no one foresaw, no one imagined, and few truly understand. It is deeply challenging because, while the finance and monetary authorities have launched very aggressive interventions over the past year, it is not yet clear whether these will successfully stabilize the financial system. My view is that these efforts have been well-conceived and will prevail. It may not be evident that they have done so, however, until 2010.

True Origins of the Crisis

We all have read and heard endless analyses of how this collapse occurred. But one widespread misperception still persists.

Conventional wisdom attributes the current crisis to the twin collapse of housing prices and the subprime mortgage market in the U.S. This is not correct. The underlying cause was an invariably lethal combination of extremely low interest rates and extremely high levels of liquidity.

Low interest rates reflected the Federal Reserve's overly accommodative monetary policy after September 11, 2001 and the recession of 2001 and 2002. The federal funds rate was held to 1% for nearly three years.

The extreme liquidity reflected what Chairman Ben Bernanke has called the "global savings glut." Namely, enormous financial surpluses realized by several developing countries, most notably China, Singapore, and the Persian Gulf oil states.

Facing low yields, this mountain of liquidity naturally sought higher returns and this led it to weaker credits. Huge amounts of capital thus flowed into the subprime mortgage sector – the 2005 and 2006 volumes were six times the long-term historical average – and towards weak borrowers of all types in the U.S., Europe, and elsewhere around the globe. As with all financial bubbles, historical default rates on these poor credits and other key lessons of history were ignored.

The flood of mortgage money pushed home prices up at unprecedented rates. The 30-year average annual appreciation rate had been 1.4 percent, but soared to 7.6 percent by the middle of the decade and ultimately reached 11 percent at the peak.

The rest is history. But, my point is that low interest rates and high liquidity caused this bubble, not home prices and subprime mortgages.

A Subpar Economic Recovery

This is the first balance sheet-driven recession in over sixty years and, unfortunately, that factor mandates a sub-normal recovery.

In the modern era, recessions have typically reflected a sequence of overheating, inflationary pressures, monetary tightening, a slowdown in the credit-sensitive industries and then a broader slowdown.

However, the current downturn reflects plummeting asset values, which have injured household balance sheets, financial sector balance sheets, and ultimately will harm even the federal balance sheet. The net worth of consumers has fallen so dramatically that they cannot spend; the capital of banks and like institutions has fallen so sharply that they cannot lend; and the federal balance sheet has now been stretched to the point that the government will have no choice but to eventually undertake contractionary actions to repair it.

The reason the recovery will be delayed and lengthy – U shaped – is that these balance sheets cannot recover quickly. First, the consumer balance sheet. Households have lost nearly $15 trillion since mid-2007, or a fifth of their net worth. They have retrenched by cutting discretionary spending, which is why personal consumption expenditures have been dropping so fast. In turn, the savings rate has risen and now stands at approximately three percent. In the long run, a higher savings rate is desirable. But, right now, it is accelerating the downward spiral of job losses and falling incomes that is driving people to save in the first place.

An important psychological element also applies. In recent years, household incomes were stagnant, but spending rose anyway in proportion to the so-called positive wealth effect. Consumers knew that their home and financial asset values were higher and felt flush. Now, this perception has reversed sharply. It will take a long time for consumer balance sheets and consumer confidence to be restored.

A second factor mitigating against a normal recovery is the damaged balance sheets of our banking sector. Since the peak, losses among U.S. financial institutions and investors have reached nearly $1 trillion. But, there could be another $1 trillion in losses to come. This is why financial institutions are not lending. Adjusted for such losses, they have little or no true capital.

Eventually, the federal balance sheet will also become a restraining factor. Weakness in revenues, the stimulus bill and continued financial rescue spending will likely move the fiscal 2009 deficit over $1.5 trillion, or more than 10% of GDP. In addition, the Federal Reserve is pursuing a zero interest rate policy, as it should. But, such growing deficits and extreme monetary ease can only be maintained for so long without provoking anxiety in world capital markets, foreign exchange markets, and among the American public. As a result, the U.S. government will likely shift to deficit reduction strategies and monetary tightening by 2011, which will then have a contractionary effect on the economy.

The Continuing Credit Crisis

The credit freeze outside the banking system has begun to thaw slightly. But, the crisis within the banking system may be at its low point.

Beyond the depository and lending system, the public markets seem to have passed their lows: the TED spread has fallen 350 basis points since its October peak, commercial paper issuances have improved modestly, and both high grade corporate bond spreads and high grade corporate bond issuances are slowly recovering. But, this represents only a small thaw, as the securitization and high yield markets are still frozen.

The banking system continues to deteriorate. A rare, severe downward spiral is currently in motion; as the value of financial assets fall, institutions must further mark down their held assets. These losses reduce their underlying capital and weaken their balance sheets. The so called “hole” – the deficiency of tangible equity compared to the true market value of those assets – only grows. This explains why the market equities of Citigroup and Bank of America have shrunk to $10 billion and $19 billion, respectively. For example, with residential real estate, commercial real estate, and business values themselves continuing to fall, there is little tangible equity in Citigroup. As long as these values continue falling, its balance sheet will continue to weaken.

As a result, the amounts of capital needed to properly shore up the banking system are still growing. This system may well remain incapacitated through the end of 2009, even if public credit markets continue to experience gradual improvement.

The Federal Policy Response to Date

The actions of the Treasury Department and the Federal Reserve over the past 18 months have been commendable. They have not been perfect, of course. Given a second chance, they might make different decisions on Lehman Brothers, AIG, and the original presentation of the TARP. But these two agencies, together with the FDIC, have provided strong leadership.

First, they have injected or guaranteed a total of $9 trillion in credit market support. Second, they have responded with creativity, from the Fed's guarantee for money market funds and commercial paper, to the rescues of Fannie Mae and Freddie Mac, to the nearly 400 separate institutions that have received TARP funds to date, and to the FDIC's guarantees of large swaths of Citigroup and Bank of America assets.

It is worth noting that the RTC was a very unpopular institution during the savings and loan crisis of the late 1980s and early 1990s. But, in retrospect, the government established it swiftly and managed it expeditiously during those years. Now, the U.S. approach to that crisis is considered successful. This time, the challenge is greater, and the recovery will be slower. But, in my view, history will render the same verdict.

The New Obama Initiatives

Although the new Administration has held office for only 38 days, it has already launched four new initiatives to attack this economic and financial crisis.

The first was the $787 billion stimulus package. It wasn't perfect and could not have been. But few argue with the necessity for big fiscal stimulus under current conditions. Yes, with the economy likely declining for the first three quarters of 2009, and possibly all four quarters, it will be hard to discern an impact this year. But, most economists forecast that GDP will decline materially less this year than had the stimulus package not been enacted. We don't yet know, of course, whether this $787 billion will turn out to be a sufficient amount. If it isn't, a second round of stimulus may be necessary, perhaps in mid-2010.

The second initiative is the Capital Assistance Program, the new term for capital infusions into financial institutions from the TARP. The Administration has made a series of improvements relative to the Bush approach. For one, banks with assets exceeding $100 billion will be subjected to a financial "stress test" to determine their financial condition in a downside scenario. Presumably, this will have the effect of dividing them into three categories: those healthy enough to forego federal capital; those too weak to survive even with federal assistance; and those who need assistance but can be stabilized as a result. The Obama Administration will also designate clear lending requirements in exchange for federal capital, as well as place limits on dividends, buybacks, acquisitions of other wealthy institutions, and executive compensation. Finally, the new program will purchase convertible preferred shares, not straight preferred shares. This allows it to turn its investment into pure equity for the benefit of the assisted institution.

Thirdly, the new Administration has decided to pursue a Public/Private Investment Fund to incentivize private capital to acquire toxic assets. This is both the right financial approach and a courageous idea, because it will not be popular. We do not yet know the details, but it likely involves providing federal loans to hedge funds, private equity funds, and similar investors. These loans will likely come from the Federal Reserve, thus not requiring legislative approval. They will likely be provided on a non-recourse basis to investors at an initial amount of $500 billion, with the potential to expand to $1 trillion as needed. It will likely take three to four months for this complex partnership to become operational. For example, the TALF facility, which was announced in November is just now commencing operations.

The public/private approach addresses two key needs. First, it removes distressed assets from the balance sheets of weakened lenders, and second, it allows the private market to price those assets. But structuring this facility correctly will be a challenge. Taxpayers must share strongly in the profits realized by investors. The financing provided must be large enough to allow for active bidding on the toxic assets but not so large as to encourage overpricing them. And private investors will likely require floor protection from the FDIC and Treasury on any assets purchased. Furthermore, it is also unclear whether subsidized bids on toxic assets will be sufficient to induce a healthy volume of selling on the part of lenders, or whether those sale prices would trigger even larger losses, requiring additional capital infusions from the Treasury.

This approach is preferable to nationalization, which has been so widely discussed in recent days.

It is important to define nationalization, before a true discussion of its pros and cons can properly be had. The right definition, it seems to me, is 100% federal ownership of a financial institution.

It is also important, given the enormous uncertainties of the moment, to avoid categorical statements. At this moment, the U.S. cannot categorically rule out nationalizations. There are possible circumstances which are so cataclysmic as to leave no other alternative.

But, that is the only circumstance in which we should resort to this step.

Here's why:

- Our government is not equipped to manage large financial institutions. For example, post-nationalization, most envision transferring an institution's toxic assets to a new formed federal institution: an aggregator bank, or "bad" bank. But, twenty years ago, it took years for the RTC to become fully operational. It would take a similarly long time here.

- Any nationalized institution would be further weakened by virtue of that step. Retaining business customers and key talent would be difficult during a period of federal ownership. Those institutions which remains in private hands would benefit, at the expense of the federalized ones.

- The temptation to direct nationalized institutions towards public policy goals, however commendable, would be severe, e.g., "green lending." Such a focus would be inconsistent with the goal of swiftly returning a nationalized entity to profitability and financial soundness.

- It would take longer to re-privatize a nationalized institution than many estimates that I have seen. Once taken over, our capital markets will see the institutions as weakened. Such markets will be slow to embrace efforts to re-sell them to investors, except at fire sale prices.

- The oft-cited Swedish example of bank nationalization is not particularly comparable. By American standards, Sweden is a small country, and these were two small institutions.

- It also is not necessary to nationalize in order to change senior management or the Board of any federally assisted institution. The Treasury has that power today. If it has furnished substantial TARP funds, it can simply request that the management or Board, or both, be replaced, as a condition of continuing the investment. Any institution would comply.

The final initiative is that towards the mortgage and foreclosure crisis. This was long overdue.

The new plan is designed to make three impacts: (1) more flexibility for Fannie Mae and Freddie Mac to acquire and to restructure mortgages; (2) greater overall capacity to restructure existing mortgage loans and ease debt service for distressed homeowners; and (3) the ability to write down principal amounts of mortgages in the context of bankruptcy.

The Fannie and Freddie changes would permit refinancings where the mortgage value exceeds 80% of the underlying home value, provided that it doesn't exceed 105% of the value. This could allow several million homeowners to refinance at lower rates, lower their mortgage debt service and stay in their homes. We should see a considerable increase in related refinancings.

Further, the Obama proposal provides cash incentives for mortgage servicers to restructure mortgages. The goal is to lower the debt service to income ratio, in as many cases as possible, to the low 30% range, including through principal reductions. It is not clear how many servicers will participate in this plan but it is the right step because it addresses borrowers who are at risk but may not yet be delinquent.

The mortgage and foreclosure crisis is difficult to address because millions of individual loan modification transactions are required. Unfortunately, it is just as time consuming to restructure a small mortgage, as it is to modify a huge one. Therefore, we face a big "retail" problem. Namely, how to actually interact with such a large number of homeowners and their mortgages. There is no magic solution here, and even the impacts of this new initiative may take some time to be felt. But, it was necessary.