Testimony of Robert E. Litan[1]

before the

Joint Economic Committee

December 2, 2009

Chairman Maloney and members of the committee: Thank you for inviting me to appear before you today.

My name is Robert Litan and I am here today primarily to discuss financial reform issues on behalf of the bipartisan Task Force on Financial Reform, of which I am a member. The Task Force is ideologically diverse and has as its members both academic economists and financial industry practitioners.[2] This group was first convened in June and given the task of producing bipartisan, consensus recommendations designed to meet one overriding goal: to create a financial system that allows the U.S. economy to grow without the kinds of risk we have recently witnessed and unfortunately experienced. I am pleased to discuss here today, together with Robert Steel, another Task Force member, the Task Force's five core principles for reform.[3]

We are meeting at critical time for the economy, underlined by the President's plans to hold a major jobs summit tomorrow. Hopefully, some creative ideas will come out of that meeting.

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[1] Robert E. Litan is Vice President of Research and Policy at the Ewing Marion Kauffman Foundation, a Senior Fellow in Economic Studies at the Brookings Institution, and a member of the Task Force on Financial Reform. The views expressed here are my own.

[2] In addition to myself, signatories of the Task Force Principles include: Martin Baily, Task Force Co-Chair, Senior Fellow, Economic Studies, Brookings Institution; Peter Wallison, Task Force Co-Chair, Senior Fellow at the American Enterprise Institute; Charles Calomiris, Professor of Finance at Columbia University; Morris Goldstein, Senior Fellow at the Peterson Institute for International Economics; Richard Herring, Professor of International Banking at the Wharton Business School; Paul G. Mahoney, Dean of the Law School at University of Virginia; Avinash Persaud, Chairman of Intelligence Capital Limited; Alice Rivlin, Senior Fellow at the Brookings Institution and Visiting Professor at Georgetown University; Robert Steel, Former CEO at Wachovia and; Benn Steil, Senior Fellow and Director of International Economics, Council on Foreign Relations .

[3] The recommendations are the views of the Task Force and do not necessarily represent the views of The Pew Charitable Trusts.

But there are already some ideas and subjects already on the table that need to be addressed if we are going to put our economy on a sustainable footing. One of those subjects is fixing the financial system. Until this happens, businesses of all sizes, large and small, cannot expect to gain the credit and financing they need as long as our financial institutions remain weak and at risk of future crises. Banks won't lend otherwise, or if they do and the incentive structures that helped lead to the recent financial crisis are not fixed, we will simply embark on yet another boom-bust cycle which none of us wants to repeat.

I understand that some feel that we should take time to better understand the causes of the financial crisis before we reform the system. While I have some sympathy with view, I also believe the danger from inaction is greater. Moreover, if we remember back to the Pecora Commission that investigated the causes of the Depression, that Commission only launched a debate that continues even today. Meanwhile, Congress did not hesitate then to act and, in my view, most of what it did to fix the financial system has stood the test of time remarkably well. Likewise, Congress should not wait this time to fix what clearly needs fixing.

I will spend little time on going through the extensive list of causes of the crisis, of which we and you know there are many: an extended period of low interest rates coupled with the continuous heavy inflow of savings from abroad; the widespread perception that U.S. housing prices would not fall; various government policies that encouraged excessive home mortgage lending; opaque mortgage backed securities (CDOs and their progeny) that were unwisely rated by the ratings agencies and insured by the monoline bond insurers; major failures in oversight of financial institutions; failures in risk management at many financial institutions; compensation structures that encouraged imprudent excessive risk-taking by mortgage originators and securitizers; unscrupulous mortgage lending practices; and so on. I know others have used this analogy, but it won't stop me from repeating it here: the culprits of this financial crisis are many, like all those on the train in the famous Agatha Christie story and movie, *Murder on the Orient Express.*

The members of the Task Force extensively debated these causes and what to do about them. We ultimately did not agree on every item of reform, or agree to take up every subject that has been connected to this crisis. But we did concentrate on some of the major issues in need of legislative attention. After much very useful and instructive back and forth discussion, we agreed on some consensus recommendations, backed by what we hope is useful analysis that will help the Congress as it goes about the critical task of reforming our nation's financial laws to dramatically reduce both the likelihood and severity of future financial crises.

In this connection, all of the Task Force members commend the Congress – both the House and the Senate – for the hard work that has been on reform so far. You will find many common elements between our recommendations and the specifics in the bills that have come out of the House Financial Services Committee and that are now being considered in the Senate Banking Committee.

It is in that spirit that I now briefly outline our five key principles of reform and a brief summary of some key recommendations. My colleague on the Task Force Robert Steel will offer some additional details on some other key Task Force recommendations.

First, the U.S. must have an early warning system that prevents inappropriate and dangerous financial practices from harming the economy.

The financial crisis revealed both gaps in regulation and unanticipated interconnections among different types of financial institutions and markets. Yet no one was charged with understanding these interconnections, looking for gaps, detecting early signs of systemic threats and acting to mitigate them. The creation of a Financial Services Oversight Council (FSOC) charged with overseeing policy on systemic stability would rectify this oversight. The Fed would carry out systemic risk monitoring and make recommendations to the FSOC, while retaining observer status on examinations of specific institutions of its choosing.

The FSOC's systemic risk policy would outline the signals of systemic threats, such as the rapid growth of credit, housing and other asset classes. The policy also would specify how and under what circumstances the responsible federal agencies should respond with measures to encourage stabilizing behavior. Such measures could include varying additions to normal standards for capital, reserves, margins, and leverage (such as loan-to-value ratios for mortgages) across institutions and markets.

Second, no financial institution should be too big or complex to fail.

We have learned many things from this crisis, but clearly one of them is that the "well capitalized" positions of many of our financial institutions, especially the larger ones, were an illusion. Financial institutions took on too much risk, while moving a lot of it ostensibly "off balance sheet" only to find that once the crisis hit, they had to take these "structured investment vehicles" back home, for a combination of reputational and legal reasons.

Going forward, a new regulatory regime must address the too big to fail problem squarely. The Task Force believes this is best accomplished by having capital, liquidity and leverage requirements rise with the size and complexity of the institution. Larger institutions that are capable of accessing the capital markets should also be required to issue a minimum amount of subordinated debt (subject to haircuts in the event of failure) that converts to equity in times of stress. In effect, this progressively tighter regulatory regime would force larger, complex institutions to have greater buffers in the event of future financial turmoil and to internalize the potential systemic risks these institutions pose to the rest of the financial institution and economy.

The Task Force also strongly endorses the notion that large institutions above a certain size maintain a "wind-up plan" approved by a single prudential financial regulator. Large, complex institutions whose plans are persistently weak should be required to divest businesses until their failure would pose significantly less risk to the financial system.

Third, one strong and smart prudential regulator should replace the current alphabet soup of agencies.

The patchwork of federal financial regulatory agencies and their jurisdictions that long pre-dated the crisis allowed regulatory capture, charter shopping, inconsistent policies, gaps in coverage, inadequate resourcing and ineffective oversight. Future arrangements must allow for the evolution of the financial system while at the same time addressing all these weaknesses. Like institutions should be subject to like regulation. As an institution changes character, there should be no regulatory barriers to corresponding changes in the manner in which it is regulated.

The Task Force believes these objectives can be best met and the problems with the current system best cured by vesting responsibility for prudential supervision and regulation in a single National Financial Regulator (NFR). The Task Force urges that no institution be pre-designated as systemically significant. The examination process must be strengthened, with more focus on risk-taking and outcomes and less on process. Better recruitment, selection, training and compensation of examiners are also needed.

Fourth, derivatives markets and market discipline broadly must be strengthened.

Derivatives markets would be more secure and transparent if all over-the-counter (OTC) derivatives were recorded with trade registries, and OTC transactions were encouraged to migrate to clearinghouses and exchanges. This is best done through the judicious use of capital required for OTC derivatives that are not centrally cleared to encourage the creation and demand for standardized OTC derivatives that are easily cleared centrally and eventually traded.

Senior executives and other risk-takers in financial institutions must be rewarded by compensation structures that provide incentives for constructive behavior, not imprudent risk-taking. Accordingly, a significant element of such compensation should consist of very longterm restricted stock (analogous to the compensation systems in traditional financial partnerships). Prudential regulation should penalize institutions that do not maintain compensation systems that are improperly aligned with risk – for example, through higher capital requirements.

Finally, consumers need better protection from financial abuses.

In recent years, unethical and deceptive practices in the sale of financial products and services became an issue in the run up to this crisis. Consumer protection was neglected even where it was mandated by statute: it was not given priority by agencies that were primarily concerned with protecting the safety and soundness of the financial institutions under their supervision.

Accordingly, the Task Force supports the creation of a new federal Consumer Protection Agency, which should have both rulemaking and enforcement powers with respect to all consumer financial products currently overseen by the various federal agencies (excluding products currently regulated by the SEC and CFTC and those offered by small service providers whose financial activities are only incidental to another business).

I am submitting the full report on the Task Force Principles along with my prepared testimony. Many of the specific Task Force recommendations in support of the Principles mirror many of the recommendations made by the Administration, as well as those under debate in the House Financial Services Committee and the Senate Banking Committee. Yet, while the Task Force was not able to address all aspects of financial regulation and some members would have preferred somewhat different approaches with respect to certain individual recommendations, those who signed the report believe strongly that this entire package, if adopted, would represent a major improvement over the status quo.

Finally, I want to close with a comment about our overall economic predicament and ways to sustain economic growth in the months and years ahead, drawing on work that I and my colleagues at the Kauffman Foundation and the Brookings Institution have been doing in recent months.

As this committee is well aware, we have just come off the first quarter of positive GDP growth in a year and a half. But our economy remains very much at risk. Unemployment is now above 10% with little prospect of dipping much below this double digit level any time soon. The nearly 3% annual growth recorded in the third quarter was boosted by a series of temporary government initiatives that eventually will be phased down or come to an end: the “cash-for-clunkers” program, the housing tax credit, the stimulus money that was in the pipeline, and the continuing provision of liquidity by the Federal Reserve.

The central question we all face now is this: how and when is private sector activity – consumption, investment and exports -- going to kick in and not only sustain overall growth, but at a sufficiently high level to start bringing unemployment down continuously and significantly? Already many ideas for another fiscal stimulus have been floated to insure that this happens. I would be pleased to give you my thoughts on these ideas in the question period.

But I close with one modest suggestion for reducing unemployment that should have little or no impact on the federal budget. Why not authorize an “entrepreneurs’ visa” – or more accurately a “job creators’ visa” – for immigrants who come here, form businesses and hire American workers? Studies have shown that immigrants account disproportionately for the formation and growth of successful high-tech companies in particular. Moreover, Kauffman Foundation research documents the centrality of new firm formation to the growth of overall employment.[4] We thus could use the energy and innovativeness of job-creating immigrant entrepreneurs now more than ever.

I look forward to any specific questions you may have about the matters I have discussed here. Thank you again for inviting me.

[4] See two studies on this topic: John Haltiwanger, Ron Jarmin and Javier Miranda, "Jobs Created From Business Startups in the United States," Kauffman Foundation, January 2009, at http://www.kauffman.org/uploadedFiles/BDS_Jobs_Created_011209b.pdf; and Dane Stangler and Robert E. Litan, "Where Will The Jobs Come From?", Kauffman Foundation, November 5, 2009, at http://www.kauffman.org/uploadedFiles/where_will_the_jobs_come_from.pdf.