Testimony of

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"Systemic Regulation, Prudential Matters, Resolution Authority, and Securitization"

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Chairman Frank, Ranking Member Bachus, and Members of the Committee, thank you for the opportunity to testify on the important topics of Systemic Regulation, Prudential Matters, Resolution Authority, and Securitization. I am a visiting professor at the McDonough School of Business at Georgetown University, and a non-resident scholar at the American Enterprise Institute. I was previously Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009.

Since I last testified before this committee on Wednesday, September 17, 2008—the week that Lehman and AIG failed and just before the introduction of the TARP legislation—a series of extraordinary measures have stabilized the financial system. These include a range of bold and innovative monetary policy actions by the Federal Reserve; a Treasury Department guarantee program for money market mutual funds; the Treasury Department's Capital Purchase Program and other measures using the TARP authority granted under the Emergency Economic Stabilization Act of 2008; and the Temporary Loan Guarantee Program (TLGP) put in place by the Federal Deposit Insurance Corporation (FDIC).[1] The stress tests carried out this year provided market participants with assurances regarding the viability of key financial firms. These actions did not prevent a deep and painful recession, but they did head off a meltdown of the financial sector that would have involved an even worse outcome for the U.S. economy.

The topics in this hearing and in the draft Financial Stability Improvement Act of 2009 concern both measures to help avoid a future crisis and proposals to change the way in which the government responds to crises should they happen nonetheless. These issues are closely related, since credible steps that provide certainty to market participants and lead them to believe that they will have costs imposed on them in a crisis would be expected to change risk-taking behavior and thus help make a future crisis less likely (though there are costs to changing investor behavior as well if this means that some productive investments are not funded and

[1] I have previously written about policy steps taken during the crisis in "The Financial Crisis: An Inside View," *Brookings Papers on Economic Activity*, Spring 2009.

thus do not take place as a result). With this in mind, it is useful to first consider the provisions in the draft legislation for new authorities once a crisis starts.

Subtitle G - Enhanced Resolution Authority

Providing new authorities in a crisis is the purpose of Subtitle G, the Resolution Authority for Large, Interconnected Financial Companies Act of 2009, which would create enhanced resolution authority for the government to take over a firm not covered by the existing FDIC resolution regime for banks. Put simply, this is a proposal for a permanent and supercharged TARP. The government would be allowed to put public money into a private firm without further authorization from the Congress, making this a permanent TARP. And the government would be authorized to repudiate contracts, making this a supercharged TARP.

Faced with a failing firm, the government would have the tools to prevent or cushion any feared potential consequences. Public money could be put into a firm to stabilize it, and/or losses could be imposed on creditors to avoid what might be feared as a chaotic collapse of an insolvent firm. In short, enhanced resolution authority would go beyond the TARP authority and would apply to a broader swathe of the financial industry without a delay for Congress to exercise its prerogative to consider whether to enact legislation.

As noted above, providing market participants with increased certainty as to the resolution of failing firms could usefully affect risk-taking behavior in a way that helps avoid future crises. But this draft legislation does not provide certainty; instead, the expansive new resolution authority provides complete flexibility. For example, the draft legislation gives an order of priority of expenses and secured claims in Section 1609 (b)(1), but then immediately follows by allowing the receiver to do differently in Section 1609 (b)(4). A better way to provide certainty would be to pursue an improved bankruptcy regime for the financial firms that motivate the resolution proposal. H.R. 3310, the Consumer Protection and Regulatory Enhancement Act of 2009, provides such an approach.

The flexibility provided by the proposed enhanced resolution authority means that it will be difficult to constrain the executive branch to carry out a fair and effective resolution. This is in addition to the well-known downside of moral hazard. Even though the resolution regime can impose losses on creditors, allowing complete flexibility potentially allows creditors to avoid these losses and this possibility will inevitably give rise to some moral hazard.

Moreover, with flexibility to deploy public resources and change contracts outside of a judicial process comes the potential for enormous mischief—and temptation to use the new power in inappropriate ways. This is especially a concern given the scope of the proposal: the enhanced resolution authority notionally covers bank holding companies and large financial firms, but given the broad use of the TARP over the past year, one can reasonably expect that this authority could be used on any firm (after all, auto companies were covered under the TARP, as were the automobile supply chain, small businesses, consumer lending, and so on). Attempting to rule out certain types of spending and allow only investments is likewise difficult, since financial engineering can easily result in asset purchases being transformed into subsidies. This would be the case with an asset purchase set up intentionally to make losses that are directed as subsidies to the desired targets.[2]

The concerns noted above are not merely theoretical, but can be seen in the actions taken in the recent bankruptcies of Chrysler and General Motors, where the presence of authority to commit public funds allowed the government to interfere with the usual working of the bankruptcy process. Contracts were change in a sense, with the capital structure rearranged to favor junior creditors over senior ones, and the automobile firms were used as conduits to transfer public resources to the auto workers' health care fund. While it is entirely legitimate for the President or others to propose the use of public funds to ensure that workers and retirees maintain access to health insurance, the dedication of such resources should be done through a vote of the Congress and not as an adjunct to a financial rescue. Moreover, the reordering of the capital structure in these government-arranged restructurings has the potential, if this serves as precedent, to lead to higher costs of financing for future projects and thus less investment and slower economic growth and job creation.

It is understandable that it would be difficult for any administration to resist the temptation to transfer public resources to a favored party through regulatory authority rather than new legislation. In these instances, it is noteworthy that the transfer of public resources and rearranging of the capital structure were undertaken even when it must have been clear that these actions would have undesirable implications for the administration's own proposal to obtain non-bank resolution authority by providing an immediate illustration of the ways in which such an authority could be misused. Again, this only serves to illustrate how difficult it will be to constrain any administration from unintended and potentially undesirable uses of the proposed resolution authority. In the event of a future crisis, it would be preferable for Congress to decide to deploy fiscal resources.

[2] For example, a foreclosure avoidance program could be undertaken by purchasing loss-making assets, where the losses are shed via financial engineering in such a way as to provide the desired subsidies that reduce the number of foreclosures (such as by subsidizing lower interest rates for borrowers facing foreclosure).

In the meantime, it would be desirable to pursue improvements in the bankruptcy regime for financial firms. For example, it could be useful to improve the coordination of bankruptcy regimes across countries to address incidents such as with the Lehman bankruptcy where assets of some U.S. investment firms were reported to have been frozen in Lehman's UK branch. And as suggested by David A. Skeel, Jr. in testimony on October 22, 2009 before the House Committee on the Judiciary, another avenue would be to reconsider the exemption of derivatives and certain other financial contracts from the automatic stay in bankruptcy.

Without non-bank resolution authority, policymakers would face a future crisis with powers akin to those that existed in September 2008 when Lehman and AIG failed. The Federal Reserve would be called upon to provide liquidity support if good collateral appeared to be available. This type of situation would be difficult for the Federal Reserve, as it has been over the course of this crisis, since the Federal Reserve would be put in the position of acting as a bridge to an uncertain fiscal action. This would be somewhat moderated by the useful proposal in Subtitle H, Additional Improvements for Financial Crisis Management, to require that the Treasury Secretary provide written approval for the Federal Reserve to invoke its emergency lender powers (the so-called section 13-3 authority under unusual and exigent circumstances). This would lend a formal recognition and acceptance by the government's fiscal authority—the Treasury Department—of Federal Reserve actions that straddle the line between liquidity support and the provision of capital.

Financial Services Oversight Council; Prudential Regulation of Companies and Activities for Financial Stability Purpose; and Improvements to Supervision and Regulation of Federal Depository Institutions

Having the Federal Reserve backstopped by a council of other regulators could be useful, but only the Federal Reserve has the broad macroeconomic overview that is essential for the role of a systemic risk supervisor. Indeed, other government agencies expressly have narrower purviews. The FDIC, for example, focuses to a considerable degree on the state of its deposit insurance fund. This is entirely appropriate, but stands at odds with a broader view of the financial system and the economy.

The ability to designate a bank holding company or a non-bank firm as an identified financial holding company (Subtitle B) is closely linked to enhanced resolution authority and thus suffers from the problems discussed above. Designation of a firm as an identified financial holding company potentially solidifies the idea of a firm being too big to fail, when the alternative of improving the bankruptcy regime would make clear that firms can fail.

An alternative to designation of particular firms as an identified financial holding company would be to focus on the activities that give rise to the fear that a firm is systemically important. If the size of a firm or particular activities give rise to concerns, then capital adjustments can be made to compensate for these activities or attributes. This is easier said than done, but so too will it be difficult to designate the smallest of the identified firms as such and not expect this to become public and thus for the firm to derive some benefit from being seen as "too big to fail."

The idea that firms should maintain plans for their own resolution ("living wills") might be useful (and in any case is not harmful), but it must be kept in mind the limitations of such plans in the face of a crisis when the circumstances facing the firm could be quite different from those envisioned when the plan was drawn up. The same is the case for proposals that rely on forms of contingent capital, such as securities that convert into common equity at pre-arranged terms during a crisis. This could prove fragile in practice—an investor will be required to invest in a firm at just the moment he or she wants to stay away. One can imagine problems arising in terms of legal uncertainty as the investor looks for an escape hatch. Moreover, the terms of such contingent capital might make it deeply unappealing for firms—so much so that a government agency will not force financial institutions to arrange for the contingent capital. While this proposal has some merit, potential difficulties should be kept clearly in mind.

Subtitle F – Improvements to the Asset-Backed Securitization Process

The requirement that securitizers retain an economic interest in the credit risk associated with the underlying assets is meant to align incentives and help avoid the deterioration of credit standards as was the case with subprime lending during the recent housing bubble. In considering regulation of securitization, it should be kept in mind that innovation in financial services is fundamentally good for the U.S. economy. Innovation such as securitization lowers the cost of funds and broadens access to credit, including for low- and moderate-income Americans. Requiring the retention of an economic interest acts as a sort of tax on securitization, and thus necessarily involves a tradeoff between avoiding a deterioration of lending standards and putting a burden on securitization that reduces its utility and thus increases borrowing costs.

With the benefits of financial innovation, however, often comes complexity, and that is certainly the case with mortgage-backed securities (MBS) and other asset-backed securities that have been at the center of the financial crisis. Indeed, complexity was a key source of uncertainty in this crisis, since market participants could not easily tell which firms were burdened by truly toxic assets and which were in better shape. The resulting uncertainty led to a broad hesitancy to invest new resources in the financial sector.

The requirement in the administration's proposal for the disclosure of loan-level data regarding the assets backing a security provides a potentially less onerous (and less costly) approach to solving the incentive problem. This could be taken a step further to have the federal government support the creation of a mortgage information database that would provide individual loan-level information on the quality of underwriting and subsequent performance of mortgages, and thereby facilitate analysis of complex MBSs and their derivatives. Similarly, this could be done for asset backed securities beyond mortgages.

Such a mortgage information database could directly address the lack of transparency and information behind the lockup of the markets for asset-backed securities that began in August 2007. Investors could use the information in the database to analyze the performance of MBSs and collateralized debt obligations (CDOs) containing the mortgages, allowing analysis to pierce the complexity of these arrangements. Ultimately, such a database could allow investors to assess the performance of mortgages originated by particular firms or even particular loan officers.

This database would create a "reputational tail" so that originators would have a connection to the future performance of mortgages and other types of loans even after they had been offloaded from their books through securitization. This reputational tail could be a less intrusive alternative to requiring lenders to keep a piece of any loans they originate—requiring that they have "skin in the game." While it might be possible for firms to effectively offset their economic exposure to the securitized assets through hedging transactions, it will be more difficult to shed the reputational tail. If an originator or securitizer is inflicting markets with low-quality assets such as mortgage-backed securities consisting of unsustainable loans, the mortgage database will help this to become known and appropriately affect the offending party's business.

Conclusion

This hearing considers the crucial questions at the center of regulatory reform in the wake of the crisis. There are no easy answers, but only tradeoffs. A key goal will be to increase the certainty of market participants as to the actions that will be taken in the face of financial market difficulties. Enhanced resolution authority is appealing for its flexibility, but this flexibility is itself a weakness. An improved bankruptcy regime provides more certainty and will ultimately better affect behavior in a way that helps to diminish the likelihood of a future crisis.

Mr. Chairman and Ranking Member Bachus, thank you again for the opportunity to appear today before the Committee. I would be happy to respond to any questions.