

**STATEMENT OF JANE D'ARISTA
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**BEFORE THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES HEARING ON
SYSTEMIC REGULATION, PRUDENTIAL MATTERS,
RESOLUTION AUTHORITY AND SECURITIZATION**

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Chairman Frank, Ranking Member Bachus and Members of the Committee, it is a privilege to appear before you to testify on the Titles of the draft legislation under discussion today. These provisions address the need to improve crisis management and offer reforms to address the long-festered problems that caused the financial sector to unravel in 2007 and 2008. It is now widely acknowledged that changes in the regulation and structure of the financial system and the behavior of its largest institutions resulted in a level of fragility that caused a freeze on lending within the financial sector and to the real economy. The proposed legislation recognizes these changes, offers remedies to deal with the problems they have caused and to prevent a recurrence of the events of 2007-2008.

While the importance of derivatives' contribution to systemic fragility has been discussed in earlier hearings, the various titles of the draft legislation under discussion today recognize that another major cause of the crisis was the interconnections among the largest financial institutions. These interconnections were the result of their borrowing and lending to one another to fund proprietary trading – the buying and selling of assets and derivatives for their own rather than customers' accounts. As the borrowing within the financial sector rose to higher multiples of their capital, the system became undercapitalized; it became more likely that any interruption in the ability of leveraged institutions to fund the huge positions their borrowings had created could erode their capital cushions to the point of insolvency.

In addition, the short-term funding strategies on which the largest institutions increasingly relied also contributed to the system's vulnerability and to an explosion of global liquidity as assets were monetized through their use as collateral for borrowing to buy more assets. The liquidity that resulted from rising leverage exacerbated the inherent procyclicality of the system, expanding credit over the course of the boom years and leading to a rapid contraction as the downturn developed.

Meanwhile, the profound change in financial structure brought about by the rise in securitization magnified the risks caused by leverage and short-term borrowing. Securitization transformed a bank-based system into a market-based system and the expansion in holdings of tradable asset-backed securities by every segment of the financial industry changed the rules of the game in ways that increased the vulnerability of non-financial sectors to disturbances originating in finance. The wider application of fair-value accounting affects banks and pension funds in ways that have introduced market risk to households,

businesses and state and local governments – a risk from which they were partially shielded under a bank-based system.

Discussions of how the problems that contributed to the crisis should be addressed tend to focus on points that lie somewhere between two distinct approaches. One relies on the discretion of authorities to identify systemic risk and on higher capital requirements to prevent future problems. Another, the so-called “macroprudential approach”, views credit expansion as the crux of the problem. It advocates two main reforms: first, a return to the quantitative restrictions that were removed by the pressure for deregulation and second, the introduction of countercyclical regulatory and monetary tools to control the growth of the financial sector and the way that growth affects the real economy.

The remainder of my testimony will elaborate briefly on these points and offer support for my view that the revival of quantitative tools offers the better approach to preventing a repetition of the problems that caused the financial crisis; that without the use of quantitative tools to strengthen the framework of prudential regulation, the risk that another systemic crisis will occur is real.

The Growth in Leverage

The rise in financial sector debt from 63.8 percent to 113.8 percent of GDP over the decade from 1997 to 2007 is a telling indicator of how leverage bloated the system.¹ Addressing the fundamental ways in which the system failed will require an understanding of how leverage contributes to liquidity in a boom, feeds bubbles and causes implosions when bubbles burst. During the credit boom that fed the housing bubble, rising levels of borrowing inflated the size of individual institutions and the financial sector as a whole, fueled the increase in financial industry profits and made possible the excessive levels of compensation doled out to managers and employees of the largest firms.

The scale of leverage was exacerbated by deregulation – in particular, the Financial Services Modernization Act (Gramm-Leach-Bliley) of 1999 that permitted banks to borrow in order to fund traditional and nontraditional financial investments and the Securities and Exchange Commission’s relaxation of the leverage limit for investment banks from \$12 to \$30 per \$1 of capital in 2004. The collapse of Bear Stearns, Lehman Brothers and AIG and the subsequent infusions of capital, loans and guarantees to creditors of the largest institutions by the Treasury, the Fed and the FDIC revealed the extent to which excessive leverage throughout the financial system had made many institutions vulnerable to any event that might threaten their ability to roll over the funding that supported their inflated balance sheets.

Proprietary Trading

Mounting leverage within the financial sector made possible the extraordinary growth in proprietary trading over the last decade as commercial banks joined investment banks and hedge funds in using borrowed funds to make investments for their own accounts rather than the accounts of customers. Profits earned by engaging in proprietary trading are larger than earnings on services to customers but also much riskier. In effect, the proprietary trading of commercial and investment banks enabled them to

¹ Board of Governors of the Federal Reserve System, *Flow of Funds Accounts*, various issues.

produce high profit levels like those the growing number of hedge funds were reporting over the same period.

Higher leverage ratios made it possible for institutions to borrow much more without adding more capital backing, to take much larger (and thus more risky) positions and to make substantial profits on investments with relatively low margins. Moreover, many institutions were attracted by an additional incentive: their trading accounts were booked off balance sheet and not monitored by regulators or scrutinized by credit rating agencies. As a result, proprietary trading exacerbated risk while leaving the system seriously undercapitalized.

An equally critical problem is that proprietary trading creates conflicts of interest as it puts institutional traders in competition with their customers. Anticipating changes in market prices based on information about clients' buy-sell orders, institutions can evade discovery or restrictions if they use off-balance-sheet trading positions to engage in "front running" by placing orders for their own accounts before executing trades for their customers. Such behavior is obviously inconsistent with their fiduciary responsibility as intermediaries. Moreover, since financial resources are ultimately derived from the earnings and savings of nonfinancial sectors, the profits financial institutions earn by trading for their own accounts produce no benefits for either the economy as a whole or for those whose money is really at risk in the game.

As proprietary trading accelerated the growth of leverage, it also caused problems for central banks in both developed and developing countries. Carry trades drove up the volume of international capital flows and exerted a substantial influence on interest rate differentials and exchange rates as institutions borrowed short-term at low interest rates to invest in higher-yielding long-term assets. At the end of the 1990s and again after 2005, the so-called yen-dollar carry trade made up a substantial share of proprietary trading. Converting yen borrowed at low interest rates into dollars to buy assets that paid higher rates depressed the value of the Japanese currency, caused the dollar to appreciate and produced gains for traders from differences in interest rates and currency appreciation. The scale of carry trade activity is unreported and unknown. But the fact that the unwinding of positions in the wake of the collapse of a large hedge fund (Long Term Capital Management) in 1998 caused the yen to appreciate 7 percent in a single day in October and 17 percent by the end of the year bears out warnings that the international markets have become an arena for speculation,²

Leverage Changes Funding Strategies

Rising levels of leverage and the growth of proprietary trading expanded the market for repurchase agreements (repos) which are essentially short-term borrowings backed by pledges of securities. In the decade from 1991 to 2001, repos used as a source of funding for commercial and investment banks, finance companies and hedge and private equity funds rose from \$230 billion to \$788 billion. By year-end 2001, liabilities for repos were larger than checkable deposits and equaled 20 percent of banks' total deposits. At the end of 2007, security repos had jumped three-fold to \$2.4 trillion before falling back to \$1.8 trillion as the credit crunch unfolded in the fourth quarter of 2008. The peak year for financial sector

² International Monetary Fund, *Global Financial Stability Report*, various issues Bank for International Settlements, *Annual Report*, various issues.

borrowing through security repos was 2006 when their increase was only one-third less than the increase in checkable and time deposits.³

The dramatic rise in the use of security repurchase agreements had the effect of intensifying the interconnectedness of financial institutions. Half or more of the financial sector's liabilities for repos in the years after 2001 were held as assets by other financial institutions. Other sources of funding for U.S. financial institutions were foreign banks and the commercial paper market. A substantial share of the commercial paper used by banks, investment banks, finance companies and other financial institutions to fund traditional investments and off-balance-sheet positions was bought and held by other financial institutions, especially money market mutual funds (MMMFs). The extent to which intra-sector borrowing and lending contributed to systemic risk was dramatically demonstrated by the threat Lehman Brothers' collapse posed for other financial institutions and the degree of government intervention it prompted.

Because such a large share of financial sector funding was borrowed in the short-term repo and commercial paper markets, the loss of confidence triggered by the Lehman bankruptcy almost immediately caused a halt in funding for the major financial institutions. Many institutions were unable to roll over the loans they had used to buy assets and were forced to sell those assets at whatever prices were offered. Others faced calls for additional collateral as prices of the assets backing outstanding loans declined. The unwillingness of financial institutions to lend to one another caused what some see as an implosion in the financial sector. Others saw the freeze as a run on the financial sector by the financial sector itself. There was no protection against the capital charges that threatened the solvency of a number of institutions. Indeed, the requirement for fair value accounting for tradable assets made the capital of financial institutions a conduit to insolvency rather than a cushion from it.

Securitization

Because of its profound impact on the structure of financial markets, securitization – packaging pooled loans for resale in securities markets – is among the most important financial innovations that emerged in the final decades of the 20th century. As the process gained momentum, a larger share of the credit banks supplied to households was transformed into securities issued by investment banks and sold to institutional investors. At the same time, there was a symmetrical shift in households' savings from banks to pension and mutual funds. As a result, the major portion of borrowing and saving by households moved to the capital markets and the scale of that shift transformed U.S. financial structure from a bank-based to a market-based system.

Securitization erased many of the protections households had enjoyed under the bank-based regulatory structure put in place by New Deal reforms in the 1930s. As the debt and savings of this sector became increasingly exposed to interest rate and market risk, the IMF noted that households had become the shock absorbers of last resort for the financial system.⁴ Subsequently, they were called on to absorb the consequences of the risks that had brought the system to collapse in 2008 when, as taxpayers, they undertook the role of rescuing financial institutions from flawed markets for opaque securitized assets.

³ Board of Governors of the Federal Reserve System, *Flow of Funds Accounts*, various issues.

⁴ International Monetary Fund, *Global Financial Stability Report*, April 2005.

The choice of securitization as a solution to a volatile interest rate environment was first made in the early 1970s as rising interest rates in the unregulated international banking market caused severe disintermediation for a domestic system in which interest rate caps had been imposed in 1933. For almost 40 years, interest rate caps had made it possible for depository institutions to make 30 year fixed-rate mortgage loans and had contributed to financial stability. But as institutions lost deposits to the external market, the government sponsored agencies (GSEs - Fannie Mae, Freddie Mac and Ginnie Mae) were authorized to create a secondary market for outstanding mortgage loans to address the problems faced by savings institutions and banks in holding mortgages in portfolio without access to funding.

The problem for these institutions intensified when, at the end of the 1970s, interest rate ceilings became meaningless as the Fed's efforts to break inflation led to rate increases that were effectively driving mortgage lenders to the brink of insolvency. The Monetary Control Act of 1980 ended rate ceilings and, given that thrifts could only make housing-related loans, their only rational response was to offer adjustable rate mortgages (ARMs) that shifted the interest rate risk to the homebuyer and proved to have only limited popularity. Meanwhile, the thrift industry continued to sink under a legacy of long-term, low-interest-rate mortgage loans. The scale of the problem was apparent in the expansion of the GSEs' role in buying and securitizing mortgages. By the end of 1983, mortgage-backed securities (MBS) issued by these agencies totaled \$253 billion or 20 percent of outstanding residential mortgages.⁵

The Secondary Mortgage Market Enhancement Act of 1984 gave securitization a further boost by exempting private issues of MBS from registration and disclosure in favor of reliance on assessments by a few nationally recognized rating agencies. After passage of the Act, the MBS market expanded rapidly as less-regulated, non-depository lenders such as mortgage brokers and finance companies increased their role in originating and selling mortgages. By the end of the 1980s, every segment of the financial industry had begun to buy, hold and trade MBS. The privileged position of the MBS market – both private and public – contributed to the build-up of the housing bubble. And as MBS filtered into every corner of U.S. financial markets and beyond, the impact of the rising price of housing gave a substantial boost – and posed a major threat – to the net worth of American households. When the bubble burst, households' net worth fell because of the drop in the prices of their homes and then fell further as the value of MBS held in pension and mutual funds declined.

Meanwhile, the absence of capital restrictions on banks' securitization exposures under the original Basel Capital Adequacy Agreement of 1988 and the unregulated status of many mortgage originators resulted in an undercapitalization of what had become the largest U.S. credit market. As the market developed, most MBS carried high ratings and continued to do so even as the volume of sub-prime mortgages increased. Credit rating agencies, originators, issuers and investors appeared to believe that securitization could actually diminish the risk of sub-prime mortgages when pooled. However, as the crisis unfolded, the absence of disclosure about the pools of mortgages backing these securities contributed to the severe disruption in confidence that exacerbated the credit crunch and made efforts to negotiate loan work-outs far more difficult than in the past. Moreover, managing the crisis has required unprecedented levels of government intervention, including the conservatorship of Fannie and Freddie.

⁵ Jane D'Arista, *Rebuilding the Framework for Financial Regulation*, Briefing Paper No 231, Economic Policy Institute, 2009.

Going forward, however, it is difficult to believe that pressure for securitizing mortgages as well as car loans and other forms of consumer credit will not continue. The removal of interest rate ceilings for depository institutions and their ongoing exposure to a volatile interest rate environment means that holding long-term mortgages and even medium-term car loans in portfolio remains a threat to solvency that no increase in capital requirements could alleviate. Reform proposals will, therefore, need to address the concerns that have been raised by this innovative financial technique.

New Rules of the Game?

Treasury Secretary Timothy Geithner has said that addressing the fundamental ways in which the system failed will require comprehensive reform – not modest repairs at the margin, but new rules of the game. Many of the provisions of the draft legislation meet those criteria and others propose needed repairs. But there are a number of issues that are not addressed.

One of the more comprehensive reforms proposed, the creation of a Financial Services Oversight Council under Title I, is a much needed addition to the regulatory framework. Its role in evaluating firms and activities that are systemically important will enhance oversight and increase the availability of information to regulatory agencies and Congress. But I am among those who argue that authority to actually designate and deal with so-called Tier I institutions should be given to the Council rather than, as under Title II, to the Fed. Much has been said about the failure of the Fed to recognize and deal with the growing fragility of the system in the years before the crisis and the fact that Title XIII requires the central bank to obtain written permission from the Treasury before using its emergency lending powers suggests that expanding Fed powers should be approached with extreme caution.

Another important contribution to reform is the move toward more comprehensive regulation of the financial system embedded in Title VIII. Increasing the Fed's role in supervising risk management standards for systemically important payment, clearing and settlement activities conducted by nonbank financial institutions and giving the Fed authority to supervise financial market utilities that have no other supervisory agency is more than a marginal repair. Nevertheless, Section 806 takes a step backward from rigorous oversight by extending lender-of-last-resort privileges to these institutions while exempting them from reserve requirements and thus freeing them from the obligation to participate as a channel for the Fed's monetary influence.

The provisions of Title III offer proposals for clarifying the regulatory framework and Title XII deals with gaps in the authority of regulatory agencies to liquidate or otherwise resolve holding companies that have been designated as Tier I institutions. They reflect the need for clarifications to meet current conditions but they do not address the causes of the financial crisis or ways to prevent future crises. Most of the relevant preventive measures in these Titles are included in the provisions of Title VI which tighten regulations for transactions involving affiliates and subsidiaries of bank holding companies.

Arguably, the most important provision of the bill in terms of crisis-prevention is Section 609 of Title VI. This section treats credit exposures on over-the-counter derivatives, repurchase agreements and reverse repurchase agreements as extensions of credit for purposes of tightening loan-to-capital limits for national banks. The provision may have the desired effect of reducing balance sheet concentrations. However, it should be strengthened by extending the margin requirements introduced in the 1930s to cover purchases

of all financial instruments, not just equities. By targeting all financial and nonfinancial investors, margin requirements would be more effective in reducing concentrations that lead to asset bubbles.

Moreover, while Section 609 makes a real contribution to changing the rules of the game, it also points up the absence of many other provisions needed for comprehensive reform. For example, the loan-to-capital limits on credits to individual non-financial borrowers under the National Bank Act should also be extended to financial institutions in order to rein in the web of interconnections that has increased systemic risk. Other quantitative measures are also needed to prevent the reemergence of institutions that threaten the stability of the system. These include maximum loan-to-value ratios on the asset side of lenders' balance sheets and – given that leverage played so large a role in exacerbating systemic risk – explicit leverage ratios for the liability side of the balance sheets of all large financial institutions.

A notable omission in the bill is the absence of provisions dealing with proprietary trading. Re-imposing leverage limits at lower levels would help moderate the activity. But given the absence of benefits to the economy and the extensive potential for conflicts of interest with customers, it could be (and has been) argued that banning the practice altogether is justified. Meanwhile, proprietary trading continues and the profits (and potential bonuses) it provides have permitted repayment of TARP funds by some large institutions. This has been interpreted as signs of renewed systemic stability. In reality it has perpetuated systemic risk and made it more difficult to remove FDIC guarantees for the liabilities of these institutions.

In dealing with problems posed by securitization, Title IX makes an important contribution in extending the registration, disclosure and reporting requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934 to securitizers of asset-backed securities. More important, it requires any securitizer to retain an economic interest in the credit risk associated with the assets underlying the securitization and adds requirements for information on loan levels, the compensation of brokers and originators and how much credit risk the originator has retained. These provisions will bring greater transparency to the process but more is needed. For example, requiring that securitized products be traded on exchanges would add real time information on prices and the volume of trading. Another improvement would be to encourage the use of covered bonds as a complement or replacement for securitization.

The use of covered bonds gives lenders access to long-term funding from investors and protects them against the interest rate and market risk of having to roll over short-term funding while holding long-term assets. It requires that assets be ring-fenced to protect bondholders against the credit risk posed by the lender while ensuring that the lender retains full exposure in the event that one or more of the loans becomes non-performing or defaults. Thus it gives both lenders and funders strong incentives to diligently screen the credit risks they assume. Over time, the use of covered bonds would alter the structure of credit markets by reviving the role of portfolio lending, effecting a profound change that would increase market stability and mitigate the effects of fair value accounting on capital held by institutions across the financial system.

In summary, I would urge the Committee to choose rules over discretion – to add the quantitative rules that can moderate the growth of financial institutions, control excessive credit expansion and prevent the recurrence of the economic tragedy we have experienced as a result of the failure of our financial system.

Thank you for your time and attention.

Proposals to Regulate Proprietary Trading

(Addendum to the Testimony of Jane D'Arista, requested by Chairman Frank)

The explosion in proprietary trading that inflated the balance sheets of large financial institutions was encouraged by the relaxation of restrictions on borrowing by banks under the Financial Services Modernization Act (Gramm-Leach-Bliley) of 1999 that facilitated the increase in lending by financial institutions to other financial institutions, and the SEC's relaxation of leverage ratios for investment banks in 2004. Regulatory proposals to rein in proprietary trading include those that would impose an outright ban on the activity by banks, as suggested by former Federal Reserve Board Chairman, Paul Volcker, and others that would do so by restricting leverage and/or limiting financial institutions' short-term borrowing. These include:

- higher capital requirements on assets banks acquire through proprietary trading.
- liquidity requirements to limit short-term borrowing by banks.
- re-imposing pre-2004 leverage ratios on investment banks.
- leveling the playing field by imposing leverage limits on all financial institutions, including the finance arms of conglomerates and hedge and private equity funds. These limits could be raised or lowered by the systemic regulator to counter either a boom or downturn.
- margin requirements on all tradable instruments, not just equities. These requirements would constrain excessive use of leverage by nonfinancial as well as financial speculators and give the systemic regulator another countercyclical tool to dampen or encourage trading in particular assets such as mortgage-backed and other asset-backed securities as well as commodities and derivatives.
- extending the provisions of the National Bank Act to limit individual and aggregate bank lending to financial counterparties in relation to capital.
- imposing a tax on securities transactions to provide a disincentive for trading.