US Congressional debates on the financial crisis: key players, policy and future regulation

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The current financial crisis started in the US housing market in 2007, and spread across the world to damage the economies of many countries including the US. Congressional hearings have played an important role in investigating how and why the crisis arose, and what needs to be done in the long and short-term to rectify the problems.

This Research Paper provides a detailed account of the key issues and perspectives raised at these hearings. Like the Treasury Select Committee in the UK, a number of influential US committees concerned with financial issues have convened hearings featuring expert witnesses from the executive branch, the federal regulators and the private sector. The paper focuses on three main issues.

First is the $700bn Troubled Asset Relief Program. The Bill received significant criticism before and after its implementation: numerous members of Congress questioned its practical implementation, the extent to which ordinary taxpayers would benefit and the risk of losses on government investments.

Second is the role of different market actors in the financial crisis. With a view to correcting the regulatory framework a number of committees investigated the actions of key players including Lehman Brothers, AIG, Fannie Mae and Freddie Mac, credit rating agencies, derivative markets and hedge funds.

Finally, this paper examines the actions of the federal regulators. A number of different perspectives on the regulators' performance emerged, while proposals to enhance the regulatory structure focused on creating a systemic regulator as well as writing new rules for the banking and mortgage sectors.

John Marshall

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Contents

Summary **1**

1 Introduction **2**

1.1 Overview of the financial crisis 2

1.2 Political response 3

Policy decisions 3

Congressional hearings 4

2 The TARP and the EESA 2008 **5**

2.1 The importance of action 5

2.2 Criticisms of the asset purchase plan 6

The mechanisms for purchasing assets 6

A bailout for 'Wall Street' not 'Main Street' 8

Oversight 9

Executive compensation 10

2.3 Early appraisals of the TARP 10

3 Examining the different players in the financial crisis **13**

3.1 The collapse of Lehman Brothers 13

3.2 AIG 16

The failure of AIG 17

AIG's bailout 19

3.3 Fannie and Freddie 21

The failure of Fannie and Freddie 21

The regulation of Fannie and Freddie 24

The future of the GSE model 26

3.4 Credit rating agencies 27

3.5 Hedge funds 31

3.6 Derivative markets 34

4 Federal regulation **38**

4.1 Appraising the federal regulators 38

4.2 Proposed changes to the regulatory framework 43

The mortgage market 43

Banking regulation 44

Supporting non-bank financial firms 46
Accounting 47
Corporate governance 48
Regulatory structure 49

Appendix - List of acronyms **53**

Summary

In September and October 2008, the US suffered a severe financial dislocation that saw a number of large financial institutions collapse in response to the culmination of a credit crisis that had begun in the summer of 2007. Congressional hearings have played an important role in investigating how and why the financial crisis arose, and what needs to be done in the long and short-term to rectify the problems. A number of committees have conducted extensive hearings examining the failures of different institutions and regulations.

This Research Paper provides a detailed account of the key issues and perspectives raised at these hearings. Like the Treasury Select Committee in the UK, a number of influential US committees concerned with financial issues have convened hearings featuring expert witnesses from the executive branch, federal regulators and private sector. However, US committees – in the House and the Senate – possess greater powers in terms of their scope, resources and capacity to ensure that important witnesses testify under oath. This paper focuses on three main issues.

First is the $700bn Troubled Asset Relief Program. This Program – which eventually passed as the Emergency Economic Stabilization Act of 2008 – was the cause of considerable, and vehement, debate in Congress amidst public uproar at the bailing out of the banking industry. Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke proposed and defended the plan to purchase troubled assets; they reiterated the necessity of the plan to mitigate further damage to the wider economy, in addition to the financial sector. However, the plan received significant criticism before and after its implementation: numerous members of Congress questioned its practical implementation (especially the problems of asset valuation, possible capital injection and Congressional oversight), the extent to which ordinary taxpayers would benefit and the risk of losses on government investments.

Second is the role of different market actors in the financial crisis. A number of committees held hearings examining the roles of key players in the financial crisis with a view to correcting the regulatory framework to prevent a recurrence of the problems that have severely damaged the US and global financial markets. An antagonistic hearing that examined the collapse of Lehman Brothers, and featured ex-CEO Richard Fuld, found that the investment bank had significantly mismanaged its risk. Discussion regarding insurance giant AIG centred on its systemic importance, the extent to which credit default swaps were to blame for the company's collapse and the effectiveness of the federal bailout. Fannie Mae and Freddie Mac – government-sponsored mortgage firms depicted as pivotal to the crisis by Republicans – were criticised for excessive lending, although the hearing failed to achieve consensus on where blame for this lay. Further hearings examining credit rating agencies, derivative markets and hedge funds found that each area had been under-regulated and had partially contributed to the crisis. A wide array of solutions – ranging from strict regulation to simple adjustments to the status quo – was suggested. A running theme, raised by both Democrats and Republicans, was anger over unjustified executive compensation.

Finally, this paper examines the actions of the federal regulators. A number of different perspectives on the regulators' performance emerged; witnesses and politicians differed over the extent to which the crisis could be attributed to Congress, failure on the part of regulatory agencies and a lack of tools to identify and resolve difficulties. Proposals to enhance the regulatory structure focused on creating a systemic regulator as well as writing new rules for the banking and mortgage sectors.

An accompanying appendix provides a list of acronyms employed in the paper. This paper may be read alongside another Library paper, *The financial crisis in the US: key events, causes and responses*, which provides an in-depth narrative and explanation of the financial crisis in the US as well as a detailed study of the US response to the crisis.

1 Introduction

1.1 Overview of the financial crisis

The US is currently experiencing a severe financial crisis. The financial dislocation started in the US housing and credit markets in mid-2007 before progressing to ensure a significant contraction in the availability of credit across financial markets more broadly. The crisis has spread across the world and severely damaged the economies of many countries.

The crisis in the US began as house prices started to fall and the number of foreclosures rose dramatically. This in turn caused credit rating agencies to downgrade their assessments of asset-backed financial instruments[1] in mid-2007. The increased risk inherent in these complex structured financial products restricted the ability of the issuers to pay interest, and reflected the realisation that the bursting of the US housing and credit bubbles would entail unforeseen losses. Between the third quarter of 2007 and the second quarter of 2008, $1.9tr[2] of mortgage-backed securities (MBSs)[3] received downgrades to reflect the reassessment of their risk.[4] This represented an immediate and severe dislocation of the financial markets:

> The odds are only about 1 in 10,000 that a bond will go from the highest grade, AAA, to the low-quality CCC level during a calendar year. So imagine investors' surprise on Aug. 21 when, in a single day, S&P slashed its ratings on two sets of AAA bonds backed by residential mortgage securities to CCC+ and CCC, instantly changing their status from top quality to pure junk.[5]

Despite the Federal Reserve's (Fed's) persistent efforts to increase market liquidity, such actions were unable to prevent rapid falls in asset prices as institutions sought to relieve themselves of their risky assets and replenish their capital ratios. Even early in 2008, large financial institutions including mortgage lenders Countrywide Financial and IndyMac and investment bank Bear Stearns collapsed.

The crisis escalated in September 2008 as a number of prominent US-based financial institutions – including insurance giant American International group (AIG), federally-sponsored mortgage banks Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac), and investment bank Lehman Brothers – collapsed and were either taken into federal ownership or allowed to fail.

Amidst runs on bank deposits, losses emanating from asset write-downs, spikes in the interest rates facing financial institutions seeking to borrow, and widespread uncertainty regarding counterparty risk, a large number of US financial institutions faced acute problems in late 2008. In particular, banks suffered from a severe liquidity crisis and a significant decline in the capital they could use to absorb losses. This, in turn, caused credit markets –

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1 A financial instrument which uses some form of asset as collateral. This included commercial paper – the short-term debt issued by firms.

2 Both billions and trillion are given in the widely used US terms. For further information, please see House of Commons Library, Statistics literacy guide: What is a billion? And other units, January 2009

3 A financial asset where a large number of mortgages are pooled together to create an asset backed by a large number of interest-yielding mortgages as collateral. MBSs are often divided into homogeneous or heterogeneous portions (or tranches) for sale to a number of investors. The asset, or one of its tranches, may be bought and sold on the market, or purchased to pay periodic interest in exchange for a fee. The cost of purchasing a MBS reflects its risk profile. In theory, by pooling mortgages the security becomes more attractive because of the fall in the risk of a substantial default. However, the expected return to the asset will remain unchanged.

4 The woman who called Wall Street's meltdown, Fortune, 4 August 2008

5 Anatomy Of A Ratings Downgrade, BusinessWeek, 1 October 2007

most pertinently the interbank and commercial paper markets – to freeze up as banks became unwilling to lend for fear of default.

In response to such news the financial markets became highly volatile. The Dow Jones Industrial Average (Dow) – an index composed of 30 of the largest publicly-listed companies, including a number of banks – saw tumultuous shifts almost daily and registered its largest ever single-day point drop in value on 29 September 2008, as well as its largest ever rise on 13 October.[6] Investor confidence fell dramatically, reflected in the flight to safer assets. Most notably, US Treasury bonds 'broke the buck': demand for secure Treasury bills was so high that their returns almost reached zero as money market firms faced significant pressures.

Credit restrictions on both firms and consumers had serious repercussions for the real economy. The Bureau of Economic Analysis found that (seasonally-adjusted) quarter-on-quarter gross domestic product declined by 6.3% in the final quarter of 2008 and a further 6.1% in the first quarter of 2009.[7] Quarter-on-quarter gross private investment declined particularly significantly: 23.0% in the final quarter of 2008 and a further 51.8% in the first quarter of 2009.[8]

For further detail on the key events, causes and responses to the financial crisis in the US, please see the accompanying Research Paper *The financial crisis in the US: key events, causes and responses*.[9] A summary of the Treasury's recommendations to reform financial regulation is available in the Standard Note *Proposals to reform financial regulation*.[10]

1.2 Political response

Policy decisions

The US response has come from a number of federal bodies, most notably the Federal Reserve (Fed) and the US Treasury.

The Fed has played a major role in addressing liquidity problems by providing a number of avenues for financial institutions to receive short term loans using collateral that the market would not accept at such generous rates. The Fed has also significantly expanded its balance sheet as part of a policy, similar to quantitative easing, known as 'credit easing'.[11]

Since October 2008 – when the US Congress passed the $700bn Emergency Economic Stabilization Act of 2008 (EESA), which enabled the Troubled Asset Guarantee Program (TARP) – the Treasury has used TARP funds to recapitalise US banks, invest in AIG and US automotive manufacturers, as well as mortgage loan modification schemes.[12] Although the new Obama administration has continued with President Bush's decision to use TARP monies to recapitalise banks in the US, it also proposed a number of further initiatives. Most notably, President Obama's Treasury Secretary, Tim Geithner, has outlined plans for a public-private asset purchase scheme, presided over the stress testing of 19 large banks and published a review of financial regulatory reform.

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[6] Dow Jones Industrial Average All-Time Largest One Day Gains and Losses, Wall Street Journal

[7] Bureau of Economic Analysis, GDP data, 29 April 2009

[8] Ibid.

[9] House of Commons Library, The financial crisis in the US: key events, causes and responses, RP09/34, 22 April 2009

[10] House of Commons Library, Proposals to reform financial regulation, SN/BT/05100, 22 June 2009

[11] This is similar to the UK policy of quantitative easing, and involves the Fed electronically "printing" money to fund the purchase of a wide range of assets including US Treasury securities, mortgage-backed assets and commercial paper.

[12] Ibid.

Congressional hearings

Committees in Congress undertake administrative, investigative, legislative and oversight duties, and receive considerable resources in terms of staff and access. Both chambers of Congress, the House and Senate, have an extensive web of committees relating to all main policy areas. Contained in each full standing committee[13] – in the House there are 20 such committees,[14] and 16 in the Senate[15] – are a number of subcommittees which examine more specific issues. The full committee, which possesses legislative jurisdiction over pre-determined areas, generally examines the broadest and most important issues.

Congressional hearings have played an important role in seeking to determine how and why the financial crisis arose, and what needs to be done in the long and short-term to rectify the problems. A number of committees have conducted extensive hearings examining the failures of different institutions and regulations with a view to improving the financial framework. A list of the main committees investigating the financial crisis and their key members is contained in the table below.

Committees examining the financial crisis in the 110th and 111th Congresses

Committee (acronym)	Chairman	Ranking Member
House		
House Committee on Financial Services (HCFS)	Representative Barney Frank	Representative Spencer Bachus
House Committee on Oversight and Government Reform (HCO)	Representative Henry Waxman (2007-2008); Representative Edolphus Towns (2009-)	Representative Tom Davis (2007-2008); Representative Darrell Issa (2009-)
Senate		
Senate Committee on Agriculture, Nutrition and Forestry (SCA)	Senator Tom Harkin	Senator Saxby Chambliss
Senate Committee on Banking, Housing and Urban Affairs (SCB)	Senator Chris Dodd	Senator Richard Shelby

The Chairman of a committee is always a member from the majority party in the chamber. The Ranking Member is the most senior member of the committee from the minority party. In the hearings examined in this paper – covering the 110th and 111th Congresses, which have run from 2007 – the Chairman is always a Democrat and the Ranking Member always a Republican.

Committees can comprise a large number of members, who are allocated places – approximately in proportion to the sizes of the majority and minority parties in the chamber – by the party leadership at the beginning of each two-year Congressional session. The HCFS, for example, currently has 50 members (or 11.5% of the whole chamber) – 30 are Democrats and 20 are Republicans. In the House, Representatives generally specialise in several main areas, while Senators usually maintain an interest across a broader and less-specialised

[13] A full standing committee is a permanent committee identified by House and Senate rules. There are also select or special committees in each chamber, as well as four joint committees. Ad hoc conference committees exist for resolving differences in the legislation passed by the two houses.

[14] US House - Committees

[15] US Senate - Committees

spectrum of interests, and accordingly are members of more committees in number and diversity. The SCB currently has 23 members (or 23% of the chamber) – 13 Democrats and 10 Republicans. Subcommittees contain a smaller number of members drawn from the full committee.

As part of their legislative and investigative functions, committees call hearings to examine particular issues. Akin to select committee hearings in the UK, the committee's chairman will convene a panel, or panels, of witnesses. Each witness submits a formal written testimony, provides an oral testimony and answers questions from members (who are allotted a given amount of time for questioning). In many committees, it is common practice for witnesses to speak under oath. For certain hearings, it is compulsory – or expected – that certain relevant witnesses from the federal government will attend; for example, the Treasury Secretary will attend hearings debating significant financial matters. The hearings can also serve as an opportunity for elected representatives to publicly convey their views on particular issues.

However, unlike in the UK, standing committees in the US do not usually produce reports and recommendations on particular topical issues. Congressional committees are instead much more involved in the construction and writing of legislation; this comes in the form of mark-up sessions where a committee votes on changes to the text of the bills it receives from the executive. Hearings and consultations are used as a means by which a committee may obtain information, expert advice and analysis to aid its performance of the mark-up function. While committees generally command a critical role in determining the precise wording of final legislation – and often whether a bill even makes it the full chamber to face a plenary vote – the extent to which its changes are binding depends on the chamber and the rules attached to an individual bill.

Transcripts and statements from Congressional hearings examined in this Research Paper have been obtained from Factiva's resources *Congressional Testimony by Congressional Quarterly Transcriptions* and *Political Transcripts by Congressional Quarterly Transcriptions*, as well as individual committee websites. Where possible, internet links have been provided. However, in many cases final transcripts have not yet been published; it is expected that they will soon appear for public access on committee websites.

2 The TARP and the EESA 2008

Amidst huge falls in stock market indices, and a rush to invest in safer assets such as gold and oil, the US Treasury – led by then-Secretary Henry Paulson – consulted with Congressional leaders regarding a bailout plan. On 20 September 2008, Paulson and the then-President George W. Bush announced the TARP – a proposal for the federal government to invest up to $700bn in the purchase of illiquid assets variously described as 'troubled' or 'toxic'. More specifically, the plan proposed that the Treasury would use a variety of market-based mechanisms to acquire troubled assets at a value close to their hold-to-maturity value (as opposed to illiquid market fire-sale price);[16] accordingly, the Treasury would expect to receive a return roughly equivalent to its initial investment.

2.1 The importance of action

Paulson – who repeatedly emphasised the importance of recovering taxpayer money in his testimony to hearings in the House and Senate – stated that "this troubled asset purchase

[16] The hold-to-maturity value of an asset is the final value that an asset is expected to realise once all payments have been made. In the case of a mortgage-backed security, this would be once all mortgage payments have been completed and interest payments subsequently made to tranche-holders in the security. The hold-to-maturity value of an asset may not be the same as the current market value of an asset under certain circumstances – for example, where the market is highly illiquid it is possible that low-demand and high supply may cause prices to fall significantly below the expected value of the asset upon maturation.

program is the single most effective thing we can do to help homeowners, the American people, and stimulate our economy."[17] Elaborating on this statement, he explained to the House Committee on Financial Services (HCFS) that:

> Let me make clear this entire proposal is about benefiting the American people, because today's fragile financial system puts their economic well-being at risk.
>
> When local banks and thrifts aren't able to function as they should, Americans' personal savings and the ability of consumers and businesses to finance spending, investment and job creation are threatened.
>
> The ultimate taxpayer protection will be stabilizing our system so that all Americans can turn to financial institutions to meet their needs – financing a home improvement or a car or a college education, building retirement savings or starting a new business.
>
> The $700 billion program we have proposed is not a spending program. It is an asset purchase program, and the assets which are bought and held will ultimately be resold, with the proceeds coming back to the government.[18]

Speaking to the Senate Committee on Banking, Housing and Urban Affairs (SCB), Fed Chairman Ben Bernanke reiterated the broader dangers of not acting:

> I believe if the credit markets are not functioning, that jobs will be lost, the unemployment rate will rise, more houses will be foreclosed upon, GDP will contract, that the economy will just not be able to recover in a normal, healthy way, no matter what other policies are taken. I therefore think this is a pre-condition for a good, healthy recovery by our economy. These institutions provide credit for homeowners. They provide credit for businesses. They create jobs.[19]

Bernanke further explained the unwillingness of private investors to help restore the banking system as resulting from

> … the complexity of these securities and the difficulty of valuation, that nobody knows what the banks are worth, and therefore it's very difficult for private capital to come in to create more balance sheet capacity so the banks can make loans.[20]

2.2 Criticisms of the asset purchase plan

Although Paulson's proposal met with general support from a Congress who agreed upon the need for swift action, it faced a number of criticisms from members of the House and Senate.

The mechanisms for purchasing assets

One mechanism for making asset purchases that was discussed was a reverse auction – an auction where multiple sellers compete to sell to a single buyer, in this case the US Treasury. This would apply across a number of different asset classes, and would seek to involve as many sellers as possible to reduce the risk of uncompetitive practices.

[17] Secretary Henry Paulson, US Senate Committee on Banking, Housing and Urban Affairs, Hearing on US Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions, 23 September 2008

[18] Secretary Henry Paulson, Hearing on the Financial Markets, House Committee on Financial Services, 24 September 2008

[19] Chairman Ben Bernanke, US Senate Committee on Banking, Housing and Urban Affairs, Hearing on US Credit MarketsRecent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions, 23 September 2008

[20] Ibid.

Secretary Paulson acknowledged the complexity of the task of administering an effective asset purchase scheme:

> We're dealing with many classes of securities. We're going to need to use different approaches in different situations. So the reason we've been general and talked about market mechanisms – we're going to have to involve experts. We're going to have to use different approaches.[21]

Paulson added:

> And so when you look at dealing with this [asset purchase scheme], we're going to have to use different approaches in different situations, and there'll be market-based approaches, and that's all – you and I can't sit here and figure out what the auction technique should be, and how to use it, and in what situations to use it.[22]

Bernanke added that reverse auctions, in theory, have a number of benefits, including reducing market uncertainty in the valuation of troubled assets – a problem that had exacerbated the balance sheet losses facing financial institutions:

> So let me come to the critical point. I believe that under the Treasury program auctions and other mechanisms could be designed that will give the market good information on what the hold-to-maturity price is for a large class of mortgage-related assets.
>
> If the Treasury bids for and then buys assets at a price close to the hold-to-maturity price, there will be substantial benefits. First, banks will have a basis for valuing those assets and will not have to use fire-sale prices. Their capital will not be unreasonably marked down. Second, liquidity should begin to come back to these markets. Third, removal of these assets from balance sheets and better information on value should reduce uncertainty and allow the banks to attract new private capital. Fourth, credit markets should start to unfreeze. New credit will become available to support our economy. And fifth, taxpayers should own assets at prices close to hold- to-maturity values, which minimizes their risk.[23]

Paulson and Bernanke recommended that the Treasury should not discourage participation in the auctions by demanding equity stakes in the sellers.

A central criticism of the plan was that it lacked clarity regarding which assets would be bought, and the means by which their fair price could be determined. Chairman of the SCB, Senator Chris Dodd, described the proposal as "stunning and unprecedented in its scope and lack of detail."[24] A report by *Forbes*, which was widely-cited in Congress, also challenged the analysis underpinning the plan:

> In fact, some of the most basic details, including the $700 billion figure Treasury would use to buy up bad debt, are fuzzy.

[21] Ibid., Secretary Henry Paulson

[22] Ibid.

[23] Ibid., Chairman Ben Bernanke

[24] Chairman Christopher Dodd, US Senate Committee on Banking, Housing and Urban Affairs, Hearing on US Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions, 23 September 2008

> "It's not based on any particular data point," a Treasury spokeswoman told Forbes.com Tuesday. "We just wanted to choose a really large number."[25]

Asset valuation proved to be a complex sticking point, neatly summarised by Republican Senator Bob Bennett:

> … if you end up paying too little to these institutions, which mark-to-market accounting might drive you to, you're not giving them the support that they need. If you end up paying too much, then there's no upside potential for the taxpayer when the time comes for you to liquidate these.[26]

Republican Senator Mike Crapo suggested that capital injections may be a more effective use of the funds.[27] On the HCFS, Representative Luis Gutierrez reiterated this point and argued that injections of preferred equity would be more beneficial:

> If the intrinsic value of these assets really is greater than the market value, then why are people not snapping them up? There are many people who would buy these assets if they believed they had value to them.
>
> On the other hand, if the market value is reflective of the intrinsic value and yet the treasury buys these assets at a premium that is higher than the market value, doesn't that represent a multi-hundred billion dollar taxpayer gift to the management of these firms, even a fraction of which could be used directly to help millions of Americans avoid foreclosure?
>
> Many of my constituents have suggested that we would be better off buying preferred stock and they have noted that there's a historical model for this type of situation, the Restructuring Finance Corporation, and acquiring a preferred equity interest would avoid this enormous moral question of pricing.[28]

A bailout for 'Wall Street' not 'Main Street'

The popular view was that the Bill – as proposed – concentrated too much on helping Wall Street and did nothing to help people facing mortgage foreclosure, for example. Democrat Senator Sherrod Brown referred to the level of anger among his constituents:

> A man from Westerville, Ohio was so concerned he took a day off work and drove to Washington this week, a seven-hour drive, to share his views with me. He quite rightly asked why we're rushing to bail out companies whose leaders got rich by gambling with other people's money.[29]

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[25] Bad News for the Bailout, *Forbes*, 23 September 2008

[26] Senator Bob Bennett, US Senate Committee on Banking, Housing and Urban Affairs, Hearing on US Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions, 23 September 2008

[27] Ibid., Senator Mike Crapo

[28] Luis Guiterrez, Hearing on the Financial Markets, House Committee on Financial Services, 24 September 2008

[29] Ibid., Senator Sherrod Brown

The operation of the plan was characterised by Republican Senator Jim Bunning as "financial socialism" – a plan that would "take Wall Street's pain and spread it to the taxpayers."[30]

Democrat Senator Jack Reed argued that participating institutions should have to pay a premium, noting that "I think the custom on Wall Street is when you assume the risk, it's because you get paid to do that."[31]

If assets were purchased at a value determined by reverse auction, Democrats Senator Evan Bayh and Representative Bill Sherman questioned why equity stakes should not be purchased to allow the taxpayer to share in potential gains to the banking sector. Senator Bayh observed:

> If we're paying above market prices, well, what do the taxpayers receive in return? If equity is the answer, that's one thing. If it's not equity, then we have to ask why not. And if it's not equity, we have to ask why do we encourage or at least permit sovereign wealth funds to invest in our companies and markets but perhaps not allow the American taxpayers to take a similar interest in our own companies and markets.[32]

When questioning Chairman Bernanke about asset valuation, Bayh added:

> And I think you have acknowledged it's an inexact science at best. So the taxpayers do bear some downside risk here. What do they get in exchange for bearing that downside risk? Why should they not be allowed to participate in the potential upside? And then that gets to the question, once again, of possible equity participation.[33]

The following day in the HCFS, Representative Sherman observed:

> If you've got too many toxic assets in your institution to be able to handle, fine, give us 80 percent of your company. That's the AIG approach. Wall Street wealth absolutely rejects that approach, because they want our money. They do not want to give us 80 percent of the upside and they don't want to give us control of the company.[34]

The Ranking Member on the Committee, Senator Richard Shelby, questioned the efficacy of previous federal schemes to mitigate the crisis, and suggested that "the absence of a clear and comprehensive plan for addressing this crisis has injected additional uncertainty into our markets".[35]

Oversight

The lack of oversight proposed in the Bill proved a frequent complaint in Congress. Although Paulson responded that oversight provisions had been left to Congress to add, the issue caused consternation for Chairman Dodd who suggested that the plan "would allow the secretary and his successors to act with utter and absolute impunity without review by any

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[30] Senator Jim Bunning, US Senate Committee on Banking, Housing and Urban Affairs, Hearing on US Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions, 23 September 2008

[31] Ibid., Senator Jack Reed

[32] Ibid., Senator Evan Bayh

[33] Ibid.

[34] Representative Bill Sherman, Hearing on the Financial Markets, House Committee on Financial Services, 24 September 2008

[35] Ibid., Ranking Member Richard Shelby

agency or a court of law."[36] In addition, Dodd added that, "After reading this proposal, I can only conclude that it is not only our economy that is at risk, Mr. Secretary, but our Constitution, as well."[37]

Democrat Senator Charles Schumer, a New York Democrat, suggested that the $700bn should be disbursed in separate portions requiring Congressional approval:

> What about doing this in tranches? Why couldn't you ask us for $150 billion and, on January 15th or January 20th, we would come back, we'd assess how this worked, and grant some more money if it's really working? Maybe, you know, the markets will have stabilized and you actually will have made money. Why ask for the full $700 billion? I never thought I'd think that $150 billion is a low sum of money, but compared to $700 billion it is, and I think it would make people sit not easily, but at least a little easier.[38]

Executive compensation

Numerous Senators and Representatives raised the issue of executive compensation and parachute payments, demanding that participating institutions be required to restrict awards. With strong public disapproval for the TARP, imposing restrictions on banker bonuses proved to be a popular message in both the Senate and the House. In the SCB, Chairman Dodd said that you could "count on it", when discussing the inclusion of executive pay caps.[39] Democrat Representative Ron Klein added that

> … the plan must include limits on executive compensation. The same people who drove these companies into the ground should not in any way whatsoever benefit from taxpayer money.[40]

Speaking to the HCFS, Secretary Paulson supported the imposition of caps on executive compensation:

> The American people are angry about executive compensation, and rightfully so. Many of you cite this as a serious problem, and I agree. We must find a way to address this in the legislation, but without undermining the effectiveness of this program.[41]

Both presidential candidates supported the use of executive pay caps. The then-Senator Barack Obama argued that this "plan cannot be a welfare program for Wall Street executives."[42]

2.3 Early appraisals of the TARP

Looking forward, Chairman Dodd argued in favour of shifting the federal response to more directly address the "root" of the financial crisis in mortgage foreclosures:

> Without addressing the cause of the crisis as swiftly, aggressively, and decisively as the administration has tackled the symptoms of the crisis, house prices will continue to fall or stagnate. And the value of assets based on mortgages, trillions of dollars of which are on the books of our major financial institutions, will continue to be virtually

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[36] Chairman Christopher Dodd, US Senate Committee on Banking, Housing and Urban Affairs, Hearing on US Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions, 23 September 2008

[37] Ibid.

[38] Ibid., Senator Charles Schumer

[39] Ibid.

[40] Representative Ron Klein, Hearing on the Financial Markets, House Committee on Financial Services, 24 September 2008

[41] Ibid., Secretary Henry Paulson

[42] Bernanke, Paulson Face Tough Audience, The New York Sun, 24 September 2008

> unknowable. To date, with few exceptions, we have not seen the required, in my view, dedication.
>
> (…)
>
> Now that the administration has taken strong measures to stabilize financial institutions, it is absolutely imperative, in my view, that we apply the same sharp and urgent focus to help the individual home owners whose plight is at the root cause of this crisis, and to the small business owners who are valiantly struggling to stay afloat in these times.[43]

Ranking Member Richard Shelby echoed Dodd's criticism of the prevailing response, and argued that:

> … unless we do something or can do something to address the underlying fundamentals of dealing with the mortgage foreclosures in real estate, we're going to be wasting, perhaps, a lot of money."[44]

Democrat Senator Robert Menendez stated the point more strongly, arguing for government action on mortgage foreclosure:

> … we can no longer sit back and hope that lenders do the right thing. We can no longer simply encourage loan modifications. That clearly does not work. We cannot ask them nicely to do this. That does not work.[45]

At a hearing in the HCO in December 2008, former chief executive officers (CEOs) from Fannie Mae and Freddie Mac also provided their backing for moves to alleviate mortgage pressures.[46]

Speaking at a SCB hearing in October, Sheila Bair, Chairwoman of the Federal Deposit Insurance Corporation (FDIC), concurred with the need to increase support for homeowners, stating that: "We are falling behind. There has been some progress, but it's not been enough, and we need to act and we need to act quickly and we need to act dramatically."[47] Bair added that "the government could establish standards for loan modifications and provide guarantees for loans meeting those standards."[48]

Neel Kashkari, the Treasury's Interim Assistant Secretary for Financial Stability, was more sanguine, and simply stated that a loan guarantee program was "something we're seriously considering".[49] However, he did emphasise that the Treasury "will look for every opportunity possible to help homeowners."[50]

As of 11 June 2009, the Treasury has invested $15.2bn in mortgage loan modification (the restructuring of homeowner loans).[51] However, this pales into insignificance compared with

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[43] Chairman Chris Dodd, US Senate Committee on Banking, Housing and Urban Affairs, Hearing on US Credit Markets: Examining Recent Regulatory Responses, 23 October 2008

[44] Ibid., Ranking Member Richard Shelby

[45] Ibid., Senator Robert Menendez

[46] US House Committee on Oversight and Government Reform, Hearing on Fannie Mae and Freddie Mac Financial Collapse, 9 December 2008

[47] Ibid., Sheila Bair

[48] Ibid.

[49] Ibid., Neel Kashkari

[50] Ibid.

[51] US Treasury, TARP Transactions Report, 11 June 2009

$237bn used for bank recapitalisation, $69.8bn invested in AIG, and the $80.3bn reserved for US automotive manufacturers.[52]

Senator Schumer suggested that the TARP funds could be more effectively employed by attaching guidelines for use. Schumer proposes four key strands:

1. "I would like the Treasury to set out goals, perhaps based upon an institution's previous lending history, for the amount of lending that each institution that receives capital injection should be doing."

2. "Treasury and the financial regulators should issue guidance to discourage institutions from using this funding to engage in the kinds of risky and exotic financial activities that got us into this mess."

3. "… any institution receiving assistance under the TARP should have to adopt a systematic and streamlined approach to loan modifications, modelled on the approach that the FDIC has utilized in institutions that it controls."

4. Treasury should issue "stronger guidance" to companies regarding executive compensation.[53]

Neel Kashkari, however, argued that it would be unwise for the Treasury to "micromanage" participating banks:

> We wanted to create a program where thousands of institutions across our country would volunteer to participate. And if we came in with very specific guidance on, you must do this, you must do that, we were afraid that we would discourage firms – discourage healthy institutions from participating. And it's the healthy institutions that we want to take the capital because they're going to be in the best position to lend.[54]

The precise nature of the crisis, and accordingly what the correct response to it would be, was also an issue raised at the SCB hearing. Chairwoman Sheila Bair argued that it was principally a bank liquidity problem – not an issue of bank solvency. However, without increased liquidity, solvency could become an issue if banks failed to obtain necessary loans. Specifically, Bair stated that:

> I think it needs to be repeated, reiterated, that banks, overall, are very well-capitalized. Yes, we have some banks with some challenges, but the vast majority are well-capitalized. This is not a solvency crisis along the lines of what we saw during the S&L [savings and loans crisis] days. We're dealing with liquidity issues, right now. And liquidity issues are harder. Sometimes the liquidity issue is the market signaling a longer-term capital solvency problem. But as the confidence problem has grown and grown, irrational fear has overtaken us somewhat. So we see institutions that otherwise are viable being threatened with closure because they can't meet their obligations.[55]

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[52] Ibid.

[53] Senator Charles Schumer, US Senate Committee on Banking, Housing and Urban Affairs, Hearing on US Credit Markets: Examining Recent Regulatory Responses, 23 October 2008

[54] Ibid., Neel Kashkari

[55] Ibid., Sheila Bair

Ranking Member Shelby questioned whether the Treasury would also purchase hedges alongside the toxic assets. Kashkari replied that "we don't have a firm policy" on such "complex" issues yet.[56]

3 Examining the different players in the financial crisis

A number of committees, but most notably the investigative House Committee on Oversight and Government Reform (HCO), held hearings examining the actions of key players in the financial crisis. These hearings generally brought together a mixture of senior executives in the relevant institutions, academics and expert observers.

A poignant observation made by Republican Representative Mark Souder was that:

> … one of the extraordinary things about this series of hearings, whether it was the bond people or the AIG people or the hedge fund people, nobody takes responsibility for anything. Nobody comes up and says I'm sorry. I may have made some judgments. I did the best I could. It's like nope, it wasn't us. And it's very frustrating to figure out what to do next if nobody's responsible for anything.[57]

3.1 The collapse of Lehman Brothers

On 15 September 2008, investment bank Lehman Brothers filed for Chapter 11 bankruptcy,[58] after it failed to raise the necessary capital to maintain its operations in the face of spiking interest rate spreads and rating downgrades for many of its assets. The failure of Lehman demonstrated that the government was not willing to bail out every bank, and this caused an immediate jump in interbank lending rates[59] and precipitated runs on a number of other financial institutions.

In a hearing at the HCO, then-Chairman Henry Waxman argued that allowing Lehman Brothers to collapse was a major mistake:

> Before the Lehman bankruptcy, Treasury Secretary Paulson and Federal Reserve Chairman Ben Bernanke told us that our financial system could handle the collapse of Lehman Brothers.
>
> It now appears that they were wrong. The repercussions of this concept reverberated across our economy. Many experts think Lehman's fall triggered the credit freeze that is choking our economy, and that made the $700 billion rescue necessary. Lehman's collapse caused a big money market fund to "break the buck," which caused investors to flee to Treasury bills and dried up a key source of short-term commercial paper. It also spread fear throughout the credit markets, driving up the costs of borrowing.[60]

Ranking Member on the HCO, Representative Tom Davis, suggested that the widespread rumours of Lehman's insolvency exacerbated the situation: "Rumors and speculative leaks fed the panic and accelerated the flight of confidence and capital from that company."[61]

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[56] Neel Kashkari, US Senate Committee on Banking, Housing and Urban Affairs, Hearing on US Credit Markets: Examining Recent Regulatory Responses, 23 October 2008

[57] Representative Mark Souder, US House Committee on Oversight and Government Reform, Hearing on Fannie Mae and Freddie Mac Financial Collapse, 9 December 2008

[58] A particular form of bankruptcy defined under US law.

[59] Historical Libor Rates for 2008, British Bankers' Association

[60] Opening statement of Chairman Henry Waxman, US House Committee on Oversight and Government Reform, Hearing on causes and effects of the Lehman Brothers bankruptcy, 6 October 2008

[61] Ibid., Ranking Member Tom Davis

However, the Fed and Treasury's decision not to bail out Lehman Brothers did not receive universal condemnation from academic and corporate figures testifying in Congress. Economist Luigi Zingales argued that the collapse caused financial reverberations of a similar magnitude to the earlier case of Bear Stearns in March 2008, where an orderly sale of the investment was brokered by the Fed:

> The proof is that if we look at what happened when Bear Stearns was bailed out, I think that, for example, the price of the credit default swap, which is an insurance on default as a measure of how risky borrowers are considered, went up the same amount it went up after the Lehman default. So I don't think that bailing out sort of Lehman would have resolved the situation.[62]

Zingales' perspective was supported by all his fellow panellists, including Neil Minow, Gregory Smith, Peter Wallison and Robert Westcott – an array of academic and business witnesses.[63]

Fed Chairman Ben Bernanke, however, denied that Lehman was "allowed" to fail. Rather, Bernanke argued that:

> On Lehman, we did not choose to let it fail. It failed because we could find no solution. But our strong preference would have been to avoid failure, because we have seen the consequences of the failure.[64]

Richard Fuld, who had been a long-time CEO of Lehman Brothers, received particular criticism for his part in the collapse. Waxman was critical of Lehman's highly leveraged operations after 2004, when its regulator – the Securities and Exchange Commission (SEC) – made a ruling that permitted additional leverage for investment banks:

> Leverage is a dangerous double-edged sword. When it works – as it did from 2004 to 2007 – it magnifies investment gains. But when asset values decline – as the subprime market did – leverage rapidly consumes a company's capital and jeopardizes its survival.
>
> Mr. Fuld's actions during this crisis were questionable. In a January 2008 presentation, he and the Lehman board were warned that the company's "liquidity can disappear quite fast." Yet despite this warning, Mr. Fuld depleted Lehman's capital reserves by over $10 billion through year-end bonuses, stock buybacks, and dividend payments.[65]

Luigi Zingales also pointed out the considerable risk of insolvency that Lehman's highly leveraged strategy ran:

> While commercial banks cannot leverage their equity more than 15 to one, Lehman had a leverage of more than 30 to one. With this leverage, a mere 3.3 percent drop in the value of assets wipes out the entire value of equity and makes the company insolvent.[66]

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62 Ibid., Luigi Zingales

63 Ibid., all panellists

64 Ben Bernanke, House Committee on Financial Services, Hearing on Oversight of the Federal Government's Intervention at AIG, 24 March 2009

65 Opening statement of Chairman Henry Waxman, US House Committee on Oversight and Government Reform, Hearing on Fannie Mae and Freddie Mac Financial Collapse, 6 October 2008

66 Ibid., Oral testimony of Luigi Zingales

Democrat Representative Brian Higgins reviewed internal emails and public statements made by Fuld, and found that

> … inconsistency with public statements made, conveying a strong position, and internal documents showing a direct contrast to that assertion, I think is very troubling with respect to the issue of trust and confidence."[67]

Chairman Waxman – who began the hearing by presenting a chart detailing the $500m Fuld had received in remuneration over the last eight years (a figure which Fuld disputes on account of the subsequent loss in stock value) – concluded his opening statement by asserting that:

> Mr. Fuld will do fine. He can walk away from Lehman a wealthy man who earned over $500 million. But taxpayers are left with a $700 billion bill to rescue Wall Street and an economy in crisis.[68]

Democrat Representative Betty McColluch added that:

> My constituents in Minnesota understand that you don't have to do something illegal to do something wrong. Imperfect federal regulation isn't a license for unethical behavior, especially when it puts taxpayers at risk.[69]

Richard Fuld, who was criticised for being evasive and unrepentant, instead blamed external factors for the failure of Lehman in his testimony at the hearing:

> As the crisis in confidence spread throughout the capital markets, naked short sellers targeted financial institutions and spread rumors and false information. The impact of this market manipulation became self-fulfilling. As short sellers drove down the stock prices of financial firms, the rating agencies lowered their ratings because lower stock prices made it harder to raise capital and reduced financial flexibility. The downgrades, in turn, caused lenders and counterparties to reduce credit lines and then demand more collateral, which increased liquidity pressures. At Lehman Brothers, the crisis in confidence that permeated the markets led to an extraordinary run on the bank. In the end, despite all of our efforts, we were overwhelmed.
>
> However, what happened to Lehman Brothers could have happened to any financial institution, and almost did happen to others. Bear Stearns, Fannie Mae, Freddie Mac, AIG, Washington Mutual and Merrill Lynch all were trapped in this vicious cycle. Morgan Stanley and Goldman Sachs also came under attack.
>
> Lehman's demise was brought on by many destabilizing factors – the collapse of the real estate market, naked short attacks, false rumors, widening spreads on credit default swaps, rating agency downgrades, a loss of confidence by clients and counterparties, and buyers sitting on the sidelines waiting for an assisted deal.
>
> Again, this is not just a Lehman Brothers story. It's now an all-too-familiar tale. It is too late for Lehman Brothers, but the government has now been forced to dramatically change the rules and provide substantial support to other institutions.[70]

[67] Ibid., Representative Brian Higgins
[68] Ibid., Opening statement of Chairman Henry Waxman
[69] Ibid., Representative Betty McCollum
[70] Ibid., Richard Fuld

Fuld, who visibly angered Representatives with his replies, stated that given the available information at the time, the firm's "decisions and actions were both prudent and appropriate."[71]

Fuld faced numerous questions about his public statements as CEO of Lehman, to which he responded: "No, sir, we did not mislead our investors. And to the best of my ability at the time, given the information that I had, we made disclosures that we fully believed were accurate."[72]

3.2 AIG

AIG, which had been the US's largest insurance company and the world's leading issuer of credit default swaps, dramatically collapsed in September 2008 amidst significant write-downs in the value of its assets and a sudden inability to obtain necessary short-term loans. Given its high level of leverage and the magnitude of its exposure to credit default swaps facing significant write-downs, AIG essentially became insolvent.

Seen to be one of the most systemically important financial institutions, the Fed and Treasury have repeatedly claimed that it was too big to fail – President of the New York Federal Reserve Bank, William Dudley, has described AIG as having an "unparalleled global footprint".[73] In a joint statement on 2 March 2009, the Fed and Treasury effectively refused to set any upper bound on the support offered to AIG:

> The company continues to face significant challenges, driven by the rapid deterioration in certain financial markets in the last two months of the year and continued turbulence in the markets generally. The additional resources will help stabilize the company, and in doing so help to stabilize the financial system.
>
> As significantly, the restructuring components of the government's assistance begin to separate the major non-core businesses of AIG, as well as strengthen the company's finances. The long-term solution for the company, its customers, the U.S. taxpayer, and the financial system is the orderly restructuring and refocusing of the firm. This will take time and possibly further government support, if markets do not stabilize and improve.[74]

Treasury Secretary Tim Geithner has justified his support for AIG:

> … AIG's failure would have caused catastrophic damage, damage in the form of sharply lower equity prices and pension values, higher interest rates and a broader loss of confidence in the world's major financial institutions. This would have intensified an already deepening global recession, and we did not have the ability to contain that damage through other means.[75]

The federal bailout of AIG came in four main instalments, and involved loans and share purchases by the federal authorities. The US taxpayer currently owns 79.9% of common equity in AIG, in addition to possessing a large number of high-tariff preferred shares. The Federal Reserve System has also provided AIG with significant credit.

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71 Ibid.

72 Ibid.

73 President William Dudley, House Committee on Financial Services, Hearing on Oversight of the Federal Government's Intervention at AIG, 24 March 2009

74 U.S. Treasury and Federal Reserve Board Announce Participation in AIG Restructuring Plan, Federal Reserve, 2 March 2009

75 Secretary Tim Geithner, House Committee on Financial Services, Hearing on Oversight of the Federal Government's Intervention at AIG, 24 March 2009

The failure of AIG

AIG's most recent CEOs, Martin Sullivan (CEO, 2005-08) and Robert Willumstad (CEO, June–Sept. 2008), both denied responsibility, suggesting that AIG's problems emerged from unforeseen circumstances.

First, both Sullivan and Willumstad pointed to mark-to-market accounting rules as being partially responsible for AIG's vast losses – both argued that since AIG intended to retain its assets until maturity, they should not have been required to face the significant write-downs that arose from short-term market illiquidity. Sullivan stated:

> When the credit market seized up, like many other financial institutions, we were forced on mark our swap positions at fire sell prices as if we owned the underlying bonds even though we believed that our swap positions had value if held to maturity. The company nevertheless began reporting billions of dollars of unrealized losses on the basis of then current market valuations.[76]

Second, Willumstad suggested that the "crisis that required AIG to accept assistance from the Federal Reserve is a crisis in confidence that has affected the entire global economy."[77] Willumstad hypothesised that the problem emerged from a vicious cycle of negative expectations and illiquid markets:

> AIG was in a vicious circle. The rating agencies were considering a downgrade largely because of market-driven liquidity concerns. But it was a downgrade or the threat of one that would trigger a liquidity crisis.[78]

Sullivan was eager to point out that AIG stopped underwriting credit default swaps (CDSs)[79] in 2005, although they had dramatically increased their involvement in the market over the year. However, Representative Maloney concluded:

> So you must have realized they [CDSs] didn't have any value. And what I'm angry about now is when you blame accountants for coming forward, looking at a product, and saying it has no value, because absolutely no one in the entire world wants to buy it. It's not their fault. You want them to say there's value there when there's none? I believe in the fair market value.
>
> If no one wants to buy it, I think there's an indication that there's no value there, that you were generating fees, making all of your employees rich, wrecking a great company, and tearing down our economy, and now turning to the taxpayers and asking us to bail you out.[80]

Testifying at a later hearing at the HCO in April 2009, Maurice Greenberg – former long-time Chairman and CEO of AIG, as well as the largest single shareholder – succinctly summarised his damning perception of the problems leading to AIG's failure after he left in 2005:

> Here's what happened: AIG continued to write credit default protection after the loss of its AAA rating. Two, not only did AIG continue doing so, but it massively increased the

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76 Martin Sullivan and Robert Willumstad, US House Committee on Oversight and Government Reform, Hearing on AIG Bailout, 7 October 2008

77 Ibid., Robert Willumstad

78 Ibid.

79 A financial derivative which, in return for a small fee, insured the holder of an asset against the risk of its default. The existence of 'naked' CDSs – CDS contracts where neither party actually held the underlying asset – created fertile ground for speculation on a firm's future creditworthiness as well as risk management.

80 Representative Carolyn Maloney, US House Committee on Oversight and Government Reform, Hearing on AIG Bailout, 7 October 2008

> risk that it took on, reportedly writing more business in the nine months after I left than the previous seven years. AIG changed the nature of the business from one focused initially in providing regulatory capital for foreign banks to one focused increasingly on subprime loans. AIG decided not to hedge its risk, even after indexes that would have permitted such hedging were available and even after AIG concluded internally that the business was too risky to continue to write new contracts and after I left the management controls that I had in place to limit risk were reportedly weakened or eliminated.[81]

The new management team that replaced Greenberg and several other executives who left in early 2005 disregarded previous risk management standards, according to Greenberg:

> My successor obviously did not pay as much attention to what he should have paid attention to. I think the new chairman who succeeded me must have paid very little attention to it, as well. And as a result, they went off on a tangent and wrote, in nine months, more than double the amount of business that we had put on in Financial Products than we did in the past seven years, and of a lower quality business.[82]

Talking specifically of the Financial Products division (AIG-FP), which was a relatively independent venture contained within AIG that underwrote its CDSs, Greenberg says “I think they got greedy.”[83]

However, Democrat Representative Elijah Cummings disputed Greenberg’s account of AIG’s failure as simply resulting from poor management after he left in 2005. Cummings suggested that Greenberg “had a significant role to play”, and pointed out that:

> What you do not mention, however, is that the company lost that rating as a result of the failures that occurred on your watch. You stepped down on March 14th, 2005, and Fitch rating service downgraded AIG's credit rating to AA the next day.[84]

Democrat Representative Paul Kanjorski accused AIG of exploiting its AAA credit rating. Kanjorski argued that, because the parent holding company held a AAA rating, it then entered a number of other markets on the back of this – for example, neither AIG-FP nor an airline leasing subsidiary offered tangible collateral on its transactions, but instead used the parent’s backing. Kanjorski questioned:

> … where do we end this potential of the use of insurance entities to collateralize other business operations, but particularly more risky business operations that, obviously, weren't too successful in a downturned economy? I mean, literally, you can say that they had capital, but that would have fast disappeared and, in fact, did, and if Treasury hadn't come in with the taxpayers' funds, we would have had a bankrupt situation…[85]

Kanjorski concluded that, “If they want to go into the leasing business, form a corporation that leases planes, totally collateralize it with equity, and go into the business.”[86]

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81 Maurice Greenberg, US House Committee on Oversight and Government Reform, Hearing on AIG, 2 April 2009

82 Ibid.

83 Ibid.

84 Representative Elijah Cummings, US House Committee on Oversight and Government Reform, Hearing on AIG, 2 April 2009

85 Ibid., Representative Paul Kanjorski

86 Ibid.

Then-Chairman Henry Waxman challenged the marginalisation of auditors who had raised concerns about AIG: when Joseph Saint Denis, a senior former SEC auditor, raised questions concerning the valuation of financial product liabilities, then-CEO Martin Sullivan told him "'I have deliberately excluded you from the valuation because I was concerned that you would pollute the process'".[87] Waxman concluded "I just find that very disturbing."[88] Saint Denis subsequently resigned. Waxman also questioned AIG's decision to deplete its capital base: "As losses were mounting and resources were getting scarce, AIG depleted its capital by over $10 billion through stock buybacks and rising dividend payments."[89]

Representative Bill Foster saw AIG as an example of a case where executive compensation incentives were misaligned with company performance. Foster asserted that if AIG had hedged against its credit default swap risks (which subsequently made significant losses and have paid out at least $80bn) then this would have reduced short-term profits, and thus executive bonuses.[90] Chairman Waxman also criticised the board's decision in 2007, at the request of then-CEO Martin Sullivan, to ignore AIG-FP's $5bn loss when calculating bonuses for the firm's top 70 executives.[91] Moreover, Waxman highlighted that Joseph Cassano – who had been head of AIG-FP, but was fired in February 2008 after the failures of the division came to light – was still permitted to receive "$34 million in unvested bonuses and put … on a $1-million-a-month retainer" justified by his in-depth knowledge of the firm's transactions.[92]

AIG's bailout

AIG's ex-Chairman and CEO, Maurice Greenberg, was highly critical of the federal bailout of AIG, pointing to a number of flaws. First, he claimed AIG's viability was fundamentally undermined in the first bailout when

> … the government imposed unrealistic financing terms on AIG in September of 2008, including approximately 14 percent interest in year one, charging interest whether AIG actually drew down funds or not.[93]

Second, upon obtaining its majority equity stake, the government "immediately announced that AIG would be liquidated, which inevitably caused employees, brokers, customers, and other business partners to flee".[94] Third, as AIG sought to liquidate, it was forced to prematurely sell assets at fire-sale prices. Finally, the government

> … advanced billions of dollars of taxpayer money to AIG instead of pursuing the opportunity to raise private capital in conjunction with providing government guarantees that would have eliminated the necessity of putting up additional cash collateral.[95]

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87 Chairman Henry Waxman, US House Committee on Oversight and Government Reform, Hearing on AIG Bailout, 7 October 2008

88 Ibid.

89 Ibid.

90 Ibid., Representative Bill Foster

91 Chairman Henry Waxman, US House Committee on Oversight and Government Reform, Hearing on AIG Bailout, 7 October 2008

92 Ibid.

93 Maurice Greenberg, US House Committee on Oversight and Government Reform, Hearing on AIG, 2 April 2009

94 Ibid.

95 Ibid.

Members of the HCFS criticised the bailout of AIG, for a number of different reasons. First, Republican Representative Scott Garrett questioned why the Fed agreed to pay out dollar-for-dollar compensation to AIG's counterparties:

> But probably more important than that whole issue is why didn't the Fed insist on negotiating with foreign and also domestic counterparties for a more reasonable resolution to these contracts, instead of paying a dollar for dollar, especially when we learned after the fact that many of these counterparties had themselves hedged their bets or hedged their exposures with AIG anyway?[96]

Ranking Member Spencer Bachus highlighted the fact that counterparties to AIG's CDS contracts willingly undertook some risk of default.[97] Secretary Geithner, who was President of the Federal Reserve Bank of New York at the time, defended this stance, arguing that there was "no legal mechanism in place" to reduce payments to AIG's counterparties.

Second, Republican Representative Edward Royce explained that "one of the reasons I thought it was important to let AIG fail is the fact that now that the government's behind them, they've got extra power in the market."[98] Royce was also concerned about the possible signal of effective government backing for AIG's debts. As evidence of uncompetitive practices, he cited a finding in the *Wall Street Journal* that AIG has lowered it prices to fend off rivals.[99]

Finally, the Fed and Treasury received significant criticism for their handling of bonuses at AIG. Republican Representative Jeb Hensarling stated that: "Taxpayer-funded bonuses paid out by failing companies who owe taxpayers money makes no sense."[100] Secretary Geithner defended his actions on the grounds that current AIG CEO, Edward Liddy, had explained that

> … the contracts for the retention payments were legally binding and pointing out the risk that by breaching the contracts, some employees might have a claim under Connecticut law to double payment of the contracted amount.[101]

Greenberg argued that the government's role should have been more focused on allowing AIG to recover and thus repay the taxpayer:

> Specifically, what should be done is to achieve this – to achieve this goal for AIG to pay back the taxpayers? One, wall off AIG Financial Products from the rest of the company and replace as many loans as possible with guarantees, extend what remains of existing loans for 20 years at possible interest rates of 5 percent. That seems to be the TARP interest rate, reduce the government's ownership to 15 percent common equity to allow private capital to be raised over time.
>
> At a later date, if necessary, and proper conditions exist, non-core assets could be sold. The current approach of announcing the sale of insurance subsidiaries simply results in people seeking employment elsewhere and taking business with them.
>
> A new senior management team of internationalists with skilled insurance capabilities should be recruited, insurance experience in the lines of business at AIG is engaged

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[96] Representative Scott Garrett, House Committee on Financial Services, Hearing on Oversight of the Federal Government's Intervention at AIG, 24 March 2009

[97] Ibid., Ranking Member Spencer Bachus

[98] Ibid., Representative Edward Royce

[99] AIG's Rivals Blame Bailout For Tilting Insurance Game, Wall Street Journal, 23 March 2009

[100] Representative Jeb Hensarling, House Committee on Financial Services, Hearing on Oversight of the Federal Government's Intervention at AIG, 24 March 2009

[101] Ibid., Secretary Tim Geithner

> in. They must be quick learners to understand AIG's business and culture. You don't buy loyalty, but rather create it through strong but fair leadership. You must have the respect of your employees and the market. There should not be an on-the-job training experience.[102]

3.3 Fannie and Freddie

Mortgage banks the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are government-sponsored enterprises (GSEs). Although chartered by Congress in the 1930s with the aim of increasing mortgage loan availability, neither firm is *statutorily* guaranteed although many believed them to be *implicitly* guaranteed. They played a central role in lubricating the housing market: Fannie and Freddie would purchase mortgage loans from approved mortgage sellers in exchange for guaranteeing future payments to the loan's originator, and this would reduce the risks facing such lenders and permit them to continue lending to the market. Fannie and Freddie would also sell MBSs to a secondary market of investors, primarily on Wall Street.

The failure of Fannie and Freddie

Edward Pinto, who served as chief credit officer of Fannie Mae from 1987 until 1989, suggested that the GSEs were highly exposed to the problem subprime[103] and Alt-A[104] mortgage markets – possibly more so than stated:

> While Fannie Mae and Freddie Mac may deny it, there can be no doubt that they now own or guarantee $1.6 trillion in subprime, Alt-A and other default-prone loans and securities. These comprise over one-third of their risk portfolio, not the 15 percent that they keep referring to during earlier testimony.
>
> They were responsible for 34 percent of all the subprime loans made in the United States, 59 percent of all the Alt-A loans made in the United States. They were not bit players in this play.[105]

A confidential presentation made by Fannie Mae's then-CEO Daniel Mudd in June 2005, cited in a HCO hearing, revealed the conscious choice of the GSEs to press ahead into the subprime market, and thus "accept higher risk and higher volatility of earnings."[106] Mudd even acknowledged the likelihood of "increasing exposure to unknown risks", while a top Fannie official subsequently warned that "the layering of risk in many of these private-label securities has not adequately been reflected in their pricing."[107]

Then-Chairman Waxman called to attention the fact that Freddie Mac's chief risk officer was fired in 2004 having suggested that Freddie should increase its mortgage standards and remove itself from situations of predatory lending.[108] Democrat Representative Dennis Kucinich was highly critical of Mudd's decision to cut the budget of Fannie's risk division by

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[102] Maurice Greenberg, US House Committee on Oversight and Government Reform, Hearing on AIG, 2 April 2009

[103] The mortgage which requires the least strict lending standards for acceptance. Although there is not precise definition of what makes a debtor subprime, it is generally assumed to entail a FICO score – a US credit rating scoring system – of less than 650. Accordingly, the interest rate on such loans was greater than that on prime loans, which satisfied more stringent lending standards.

[104] Alt-A (or Alternative A) mortgages were similar to prime mortgages (see below), but required more limited documentary evidence. For example, no formal evidence of income was required for such a mortgage.

[105] Ibid., Edward Pinto

[106] Ibid., Opening Statement of Chairman Henry Waxman

[107] Ibid.

[108] Ibid.

16% at a time when they had increased their interests in the risky subprime and Alt-A mortgages markets and when their chief risk officer was warning of the paucity of procedural controls. Kucinich concluded that this "is the case of a cop being told don't go there by not giving him enough resources."[109]

Republican Representative John Mica singled out ex-CEO of Fannie Mae, Franklin Raines, for particular criticism for his role in reducing Fannie's reserves, lowering borrowing standards and receiving $90m in compensation for his work.[110]

Ranking Member Tom Davis argued that Fannie and Freddie's actions lie at the centre of the financial crisis. Like many other Republicans – who across Congressional hearings consistently depicted the GSEs as being a, if not *the*, key force underpinning the financial turmoil (Representative Mica even said "Any [investigative] hearing that does not start with Fannie is a sham"[111]) – Davis argued that:

> At that core lies Fannie Mae and Freddie Mac: Government-sponsored enterprises that dominated the mortgage finance marketplace and gave quasi official sanction to the opaque, high-risk investments still radiating global toxic shock waves from the epicenter of their subprime sinkhole.[112]

Edward Pinto supported this highly critical perspective:

> Their purchases were a major factor in the development of the housing bubble and in the huge number of defaulted mortgages, which are now causing massive declines in house prices. Without Fannie and Freddie's actions, we would not have this unprecedented housing crisis.[113]

Former Treasury Secretary under President George Bush Jnr., John Snow, suggested that these government-sponsored enterprises "represented a huge systemic risk."[114] Luigi Zingales pointed to failures at Fannie and Freddie in the heart of the securitisation process. In particular, the incentives they faced ensured that they were highly invested in AAA-rated MBSs, and suffered badly when they started to default:

> The market was not completely fooled by this process. Triple-A rated asset backed securities at a higher yield than called for Triple-A, was a clear indication of the higher risk. Importantly, regulatory constraints created inflated demands for these products. Fannie Mae and Freddie Mac were allowed – even induced – to invest their funds in these securities, creating an easy arbitrage. They issued AAA rated debt and invested in higher-yield AAA rated debt.[115]

Particularly in the case of purchasing additional AAA-rated tranches of MBSs, Professor Thomas Stanton pointed out the incredible failure of their due diligence:

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[109] Ibid., Representative Dennis Kucinich

[110] Ibid., Representative John Mica

[111] Representative John Mica, US House Committee on Oversight and Government Reform, Hearing on causes and effects of the Lehman Brothers bankruptcy, 6 October 2008

[112] Opening Statement of Ranking Member Tom Davis, US House Committee on Oversight and Government Reform, Hearing on the role of Federal Regulators and the Financial Crisis, 23 October 2008

[113] Ibid., Edward Pinto

[114] Ibid., Testimony of John Snow

[115] Oral testimony of Luigi Zingales, US House Committee on Oversight and Government Reform, Hearing on causes and effects of the Lehman Brothers bankruptcy, 6 October 2008

> When you buy $200 billion of AAA rated mortgage securities backed by Alt-A and sub-prime mortgages and you don't ask your own risk analysts to run those mortgages through the filter in order to do due diligence and check on the rating agencies, you're asking for trouble.[116]

Then-Chairman of the SEC, Christopher Cox, added that:

> I think there is no question that the GSE's, Fannie Mae and Freddie Mac, played a significant role in the subprime crisis and, in fact, in the creation of structured securities and the market for those.[117]

Financial expert Charles Calomiris concluded that "the crisis would have been less than half as large as the actual crisis if the GSEs had stuck to their traditional roles as prime lenders."[118]

However, former Fed Chairman Alan Greenspan argued that Fannie and Freddie were "a significant factor, but not the primary cause."[119] Chairman Waxman suggested that "they were following the market, not leading it."[120]

Richard Syron, CEO of Freddie Mac from 2003 until 2008, instead attributed the magnitude of the GSEs' losses to legislation preventing them from diversifying away from mortgages. Syron suggested that it was inevitable that such firms would suffer severely in the case of the collapse of the housing market:

> Freddie Mac was, is, and by law must be a non- diversified financial services company limited to the business of residential mortgages. Given the recent severe nationwide downturn in the housing market, the only nationwide housing decline in housing values since the Great Depression, any company limited exclusively to the line of business – that line of business alone would be severely impacted.[121]

The former CEOs of Fannie and Freddie generally argued that regardless of subprime losses, the GSEs would have struggled to stay afloat given the substantial tide of foreclosure pressures exerted by a 30% fall in house prices – regardless of mortgage type. Mudd explained that:

> I am not completely up to date on the figures, Congressman, but I think that of a single segment of the book, the largest losses come from Alt-A. But the predominance of the book, the old A rate 85 percent of the book is also producing about half the loans as the housing market has gone down by 30 percent.

However, the former executives pointed out that further detailed analysis needed to be provided. Representative Paul Kanjorski, one Democrat amongst many who sought to defend the GSEs in certain respects, also questioned whether the GSEs were hurt specifically by their riskier investments, rather than a significant housing correction that damaged all kinds of mortgages:

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[116] Thomas Stanton, US House Committee on Oversight and Government Reform, Hearing on Fannie Mae and Freddie Mac Financial Collapse, 9 December 2008

[117] Chairman Christopher Cox, US House Committee on Oversight and Government Reform, Hearing on causes and effects of the Lehman Brothers bankruptcy, 6 October 2008

[118] Ibid., Charles Calomiris

[119] Ibid., Alan Greenspan

[120] Opening Statement of Chairman Henry Waxman, US House Committee on Oversight and Government Reform, Hearing on Fannie Mae and Freddie Mac Financial Collapse, 9 December 2008

[121] Ibid., Richard Syron

> If there had never been subprime mortgages in the portfolio of Fannie and Freddie, would it still have difficulty because of the precipitous fall of valuation of the real estate market of this country, particularly where you're so heavily involved in California, Florida, Nevada and states that have really suffered that devaluation?[122]

Richard Syron pointed out that the subprime and Alt-A markets were a private sector innovation which the GSEs only joined shortly before their collapse – partly at the behest of Congress;

> In fact, in the midst of turmoil, when other companies decided not to invest, the GSEs were specifically required to take up the slack. This had worked through several recessions, in the Russian debt crisis of 1998, in the aftermath of 9/11—but not in 2008. The housing market went into a free fall, and with some predicting a decline of as much as 30% from peak, a business model requiring a company to continue to support the entire market could not flourish.[123]

Daniel Mudd's testimony supported this sentiment: "In fact, in the midst of the present turmoil, when other companies decided not to invest, the GSEs were specifically charged to take up the slack."[124]

Republican Representative Lynn Westmoreland was highly critical of the performance of Fannie and Freddie's executives, arguing that they should have been more prescient given their large remuneration:

> You know, I'm glad that I came to the hearing today to learn that none of you all had anything to do with Fannie Mae or Freddie Mac going south; that you all were getting paid a million dollars a year, millions of dollars a year. But you didn't know anything was wrong. You didn't have any idea that it was going south. And none of you seem to have done anything about it.[125]

Representative Kucinich reinforced the point, criticising the former CEOs of Fannie and Freddie for not taking responsibility for their actions:

> It's almost like hearing your response that I don't know nothing, no responsibility, no accountability. Stuff just happens. It's the housing market. It's the economy. It's the poor people wanting homes. But the facts show, gentlemen, that many of you at this table did know the risks and that you were warned not to take them and that you ignored your internal adviser, your chief risk officer.[126]

The regulation of Fannie and Freddie

In a derivatives hearing in October 2008 at the SCA, Senator Mel Martinez stated that Fannie and Freddie "did not have a world-class regulator."[127] Republican Representative Chris Shays, speaking in the HCO, asked the panellists:

[122] Ibid., Representative Paul Kanjorski

[123] Ibid.

[124] Ibid., Testimony of Daniel Mudd

[125] Ibid., Representative Lynn Westmoreland

[126] Ibid., Representative Dennis Kucinich

[127] Statement of Senator Mel Martinez, Senate Committee on Agriculture, Nutrition and Forestry, Hearing on the Role of Financial Derivatives in Current Financial Crisis, 14 October 2008

> Did it ever strike you as curious that the second highest ranking asset company [Fannie Mae] in the marketplace and the fifth [Freddie Mac] were not under any oversight by the SEC?[128]

Gregory Smith, general counsel of the Colorado Public Employees Retirement Association, argued that Fannie and Freddie, particularly because of their privileged position in the lending markets, should have been regulated more strongly but that this had been resisted by Congress:

> It was necessary in the case of a Fannie Mae and Freddie Mac. These two companies were seen in the market as backed by the federal government. As a result, investors did not worry about the risks of lending to them, since Uncle Sam would bail them out if the companies got into financial trouble. Investors have been proved right.
>
> (…)
>
> Yet Congress resisted reforming Fannie Mae and Freddie Mac until it was too late. And even then the reform legislation wouldn't have been passed unless it had been attached to a housing bill that Congress wanted to adopt before going home for the August recess.[129]

Representative Shays, in his final hearing before leaving the House, identified the huge force of lobbyists commissioned by Fannie and Freddie as critical in preventing regulatory reform:

> Ed Markey, Democrat, and I just said, "OK, let's regulate Fannie and Freddie like any other company" in 2002 and 2003. Well, I'll tell you something hit the fan, because every lobbyist that I've ever met was knocking down our door. Fannie and Freddie paid lobbyists to lobby for them, and they paid lobbyists on retainer so they wouldn't lobby against them.
>
> And so we have $175 million spent in 10 years on lobbying Congress. And this is a quasi-government organization that felt it had to manipulate Congress, and it did.[130]

John Snow, Treasury Secretary under President Bush, listed a number of specific flaws in the minimal regulatory structure:

> We called for a disclosure. We called for application of the securities laws. We called for a regulator who would have authority over capital standards. We called for a regulator who could limit the growth of their portfolios. We called for a regulator who could limit the lines of business they could get into, and, most importantly, to deal with the implied guarantee, which was at the heart of the problem, the fact their paper traded like U.S. government paper.
>
> We called for a regulator with the ability to have a restructuring through liquidation and bankruptcy of those entities, sending a clear message to the markets that they weren't, quote, too big to fail.
>
> I think if we had acted then, Mr. Chairman, there may not have been the need for this hearing today.[131]

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[128] Representative Chris Shays, US House Committee on Oversight and Government Reform, Hearing on the AIG Bailout, 7 October 2008

[129] Gregory Smith, US House Committee on Oversight and Government Reform, Hearing on causes and effects of the Lehman Brothers bankruptcy, 6 October 2008

[130] Ibid., Representative Chris Shays

Shays added that Fannie holding capital equivalent to just 3% of their assets was entirely out of kilter with the financial industry and subject to huge risk in bad times. Similarly, economist Arnold Kling stated:

> By requiring Freddie Mac and Fannie Mae to hold less capital than banks, our regulatory system encouraged Freddie Mac and Fannie Mae to grow at the expense of traditional depository institutions. That turned out to be dangerous.[132]

The future of the GSE model

The future of the GSEs, however, is complex. Alice Rivlin, founding director of the Congressional Budget Office, stated:

> These institutions were told that they were private companies whose job was to make money for their shareholders and that they should not expect federal help if they failed. At the same time, they were told to further the public purpose of expanding affordable housing and put some of their profits into revitalizing low income communities. While the collective delusion held, these objectives were compatible. Fannie and Freddie borrowed huge amounts – arguably at marginally favorable rates – because lenders did not believe they would be allowed to fail-bought a lot of mortgages, including subprime, made high profits, and supported a lot of worthy projects. But their rapid growth helped fuel the bubble, and when the collective delusion collapsed, they had to be taken over by the government. In the end we will have to decide whether we want Fannie and Freddie to be public utilities supporting the secondary mortgage market or truly private (and presumably much smaller) private entities that disappear into the private financial sector.[133]

Daniel Mudd argued that a more precisely defined position for the GSEs is necessary for their continued existence:

> I would advocate moving the GSEs out of No Man's Land. Events have shown how difficult it is to balance financial, capital, market, housing, shareholder, bondholder, homeowner, private, and public interests in a crisis of these proportions. We should examine whether the economy and the markets are better served by fully private or fully public GSEs.[134]

Asked about the difficulty of juggling the GSEs' responsibilities to shareholders and the government, Mudd testified that the model was difficult to maintain during difficult times:

> … what I found personally was that due to the hybrid nature of the company, a private company with a public mission, that charter, that structure gives rise to a number of challenges that become conflicts that become this very difficult balancing act that you described between shareholders, homeowners, taxpayers, capital, liquidity, stability, which market to be in.
>
> In a good market, in a rising market, it's possible to make the tradeoffs to keep that balance in a pretty effective place. In a crisis of these proportions, you can't manage the dial. And as you know from your work on the Financial Services Committee, you

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131 Testimony of John Snow, US House Committee on Oversight and Government Reform, Hearing on the role of Federal Regulators and the Financial Crisis, 23 October 2008

132 Arnold Kling, US House Committee on Oversight and Government Reform, Hearing on Fannie Mae and Freddie Mac Financial Collapse, 9 December 2008

133 Testimony of John Snow, US House Committee on Oversight and Government Reform, Hearing on the role of Federal Regulators and the Financial Crisis, 23 October 2008

134 Testimony of Daniel Mudd

> could see that some of the dies we had to sub-optimize whether it was in terms of the affordable housing mission or the liquidity mission at any given point in time.[135]

However, former CEO of Fannie Mae, Franklin Raines, maintained that "it will be hard to find a model that has more benefits and fewer demerits than the model that worked reasonably well for almost 70 years at Fannie Mae."[136] Richard Syron was more circumspect and proposed a review of what the GSEs got right in an effort to shift toward a more sustainable model based on long-term fixed-rate mortgages and a more diverse financial base for the GSEs:

> I think it is worth doing a very thorough commission or review of how these organizations are structured and see what we can learn from this and how we can capture the benefits of the long-term, fixed-rate mortgage and ameliorate some of the concerns that come out of being, for example, a monoline company.[137]

Arnold Kling recommended adopting a new system based on traditional lending structures and employing uniform capital requirements:

> Rather than try to revive Freddie Mac and Fannie Mae, I would recommend that Congress encourage a mortgage lending system based on 30-year mortgages originated and held by old fashioned banks and savings and loans. This would require instructing the regulators of Freddie Mac, Fannie Mae, banks and savings and loans to all use the same capital standard for mortgages, one that is based on a stress test methodology.[138]

3.4 Credit rating agencies

Credit rating agencies (CRAs) have assumed an increasingly important role in the modern finance sector. Not only are they widely used to determine the default risk of firms and countries issuing debt (and thus interest rates), but they became key players in rating the risks associated with complex structured financial products such as MBSs and collateralised debt obligations (CDOs).[139] Products which they had once rated as AAA – the lowest possible level of risk – were dramatically downgraded in 2007 and 2008 as the CRAs reassessed the risks involved in these products in the context of the collapsing US housing market.[140] The consequence was dramatic write-downs in the value of assets on the books of many financial institutions and a seizure in the issuance and trading of such products.

Devon Sharma, current CEO of Standard and Poors, concluded that "events have demonstrated that the historical data we used and the assumptions we made significantly underestimated the severity of what has actually occurred."[141]

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[135] Ibid., Daniel Mudd

[136] Ibid., Franklin Raines

[137] Ibid., Richard Syron

[138] Ibid., Arnold Kling

[139] A financial asset where a large number of assets – often interest-yielding debts – are pooled together to create an asset backed by these underlying assets as collateral. CDOs may be divided into homogeneous or heterogeneous portions (or tranches) for sale to a number of investors. The CDO, or one of its tranches, may be bought and sold on the market, or purchased to pay periodic interest in exchange for a fee. The cost of purchasing a CDO reflects its risk profile. In theory, by pooling assets the security becomes more attractive because of the fall in the risk of a substantial default on payments from the underlying assets. However, the expected return to the asset will remain unchanged.

[140] Eg Anatomy Of A Ratings Downgrade, *Business Week*, 1 October 2007

[141] Testimony of Devon Sharma, US House Committee on Oversight and Government Reform, Hearing on the Credit Ratings Agencies and the Financial Crisis, 22 October 2008

At the HCO hearing on the role of CRAs in October 2008, the committee heard that the CRAs suffered from conflicts of interest and a lack of competition in an industry where the issuers generally required two separate ratings to sell an asset to investor. The three largest CRAs – Fitch, Moody's and Standard and Poor's – control more than 90% of the global market in credit ratings. Sean Egan, managing director of Egan-Jones Ratings, explained:

> Issuers paid huge amounts to these rating companies for not just significant rating fees but, in many cases, very significant consulting fees for advising the issuers on how to structure the bonds to achieve maximum Triple A ratings. This egregious conflict of interest may be the single greatest cause of the present global economic crisis. This is an important point which is often overlooked in the effort to delimit the scope of the across-the-board failures of the major credit rating firms. This is not just a securitization problem.
>
> The credit rating industry is a five to $6 billion market with these three companies, S&P, Moody's and Fitch, controlling more than 90 percent of the market. With enormous fees at stake, it is not hard to see how these companies may have been induced at the very least to gloss over the possibilities of default or, at the worst, knowingly provide inflated ratings. Again, the problems were not just in structured finance, but also the unsecured bonds and other plain vanilla debt offerings of many of the corporate entities participating in the mortgage market.[142]

The hearing revealed a private presentation to the Moody's board in October 2007 where Raymond McDaniel – then Head of Corporate ratings, but Chairman and CEO at the time of the hearing – concisely summarised the danger of a conflict of interests where a firm being paid by the issuer provides ratings for their securities:

> It turns out that ratings quality has surprisingly few friends: issuers want high ratings; investors don't want rating downgrades; short-sighted bankers labor short-sightedly to game the rating agencies for a few extra basis points on execution.
>
> (…)
>
> Moody's for years has struggled with this dilemma. On the one hand, we need to win the business and maintain market share, or we cease to be relevant. On the other hand, our reputation depends on maintaining ratings quality (or at least avoiding big visible mistakes). For the most part, we hand the dilemma off to the team MDs to solve. As head of corporate ratings, I offered my managers precious few suggestions on how to address this very tough problem, just assumed that they would strike an appropriate balance.[143]

Republican Representative Mark Souder added:

> But by the way, in agriculture, agriculture does fund some of the inspectors, but the reason they don't have a conflict of interest is they know if there's tainted meat, or tainted chicken, or anything like that, their entire category goes under. Nobody will buy their meat, as in mad cows, and that there can be a conflict of interest, and still, in fact, maintain inspectors. The problem is if they're incompetent, and greedy, and corrupt and behaving illegally, then the conflict of interest pushes them over the top and they

[142] Ibid., Sean Egan

[143] Confidential Presentation to Moody's Board of Directors, October 2007 US House Committee on Oversight and Government Reform, Hearing on the Credit Ratings Agencies and the Financial Crisis, 22 October 2008

> destroy their industry, which is what happened here. It has not happened in agriculture.[144]

Democrat Representative Stephen Lynch, referring to an internal Standard and Poor's document contemplating the (perceived) decision of Moody's to lower their rating standards to secure a high-fee deal, commented:

> So he's not stealing good ideas here. He's not being innovative here. He's just ignoring, you know, some important factors in the deal in order to give them a higher rating, but doing so is lowering his standards. So we're not talking about competition by innovation. We're talking about competition by Sergeant Schultz basically ignoring what's going on, looking the other way.[145]

The situation was accentuated by investment bankers who produced securities to meet the minimum requirements to obtain a AAA-grade rating. Economist Luigi Zinagles identified that

> … instead of submitting an issue to the rating agency's judgment, investment banks shop around for the best ratings, and even received handbooks on how to produce the riskiest security that qualified for a Triple-A rating.[146]

Internal staff communications from the world's three main CRAs were presented at the HCO hearing. These highlighted that analysts found problems in the models used to evaluate risk at an early stage and some presciently predicted impending systemic collapse. One Standard and Poor's manager emailed a senior risk analyst to say:

> Any request for loan level tapes is TOTALLY UNREASONABLE!!! Most investors don't have it and can't provide it. Nevertheless we MUST produce a credit estimate.[147,148]

Another analyst concluded:

> Rating agencies continue to create an even bigger monster – the CDO market. Let's hope we are all wealthy and retired by the time this house of cards falters.[149]

Frank Raiter, an ex-risk analyst with Standard and Poor's, testified to the HCO that he had not been happy with the changes in the collateral underpinning mortgage lending, and highlighted that an updated and more complex model, able to distinguish between the different mortgage categories, had not been used, the reasons for which are disputed.[150] Raiter added that the quality of ratings surveillance – the process where ratings are monitored and potentially re-graded – was limited by the incentive to profit from resisting downgrades, and did not even employ the advanced statistical models used by the initial ratings department.[151] Furthermore, an internal email at Moody's criticised the refusal to factor the risk of interest rate rises into their models.[152]

The regulation of CRAs proved a controversial issue on the HCO. A number of members of the House, including Democrat Representative John Yarmuth, challenged the SEC for failing

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[144] Ibid., Representative Mark Souder

[145] Ibid., Representative Stephen Lynch

[146] Oral testimony of Luigi Zingales, US House Committee on Oversight and Government Reform, Hearing on causes and effects of the Lehman Brothers bankruptcy, 6 October 2008

[147] The files providing the details of the loan which are stored on computer tapes to save space.

[148] E-mail from Frank Raiter to Richard Guglia da et al., March 20, 2001, US House Committee on Oversight and Government Reform, Hearing on the Credit Ratings Agencies and the Financial Crisis, 22 October 2008

[149] Ibid., E-mail from Belinda Ghetti to Nicole Billick, et al., December 16, 2006

[150] Ibid., Testimony of Frank Raiter

[151] Ibid., Testimony of Frank Raiter

[152] Ibid., E-mail from Yo-Tsung Chang to Joanne Rose, et al., May 25, 2004

to effectively regulate CRAs; SEC Chairman Christopher Cox instead argued that sufficient regulatory powers did not exist:

> COX: … Make no mistake, credit rating agencies did not have a regulator, were not regulated. And all that they were going to get was voluntary. Voluntary regulation does not work. We have seen it over and over again.
>
> YARMUTH: I would agree with that. But I still don't understand your point that you couldn't decertify these agencies. If you say that basically certification was a rubber stamp. What if you took the rubber stamp away?[153]

In his introductory remarks, then-Chairman of the HGO, Henry Waxman, noted:

> Six years ago, Congress pressed the SEC to assert more control over the credit rating agencies. In 2002, the Senate Governmental Affairs Committee investigated the rating agencies and found serious problems. The committee concluded that meaningful SEC oversight was urgently needed. The next year, the SEC published its own report, which also found serious problems with credit rating agencies.
>
> Initially, it looked like the – initially, it looked like the SEC might take action. In June 2003, the SEC issued a concept release seeking comments on possible new regulations. Two years later, in April 2005, SEC issued a proposed rule.
>
> Yet despite the Senate recommendation and SEC's own study, the SEC failed to issue any final rule to oversee credit rating agencies. The SEC failed to act and left the credit rating agencies completely unregulated until Congress finally passed a law in 2006.[154]

Recommendations to reform the CRAs have focused on reforming the 'issuer pays' model. Former Moody's executive, Jerome Fons, cautioned against reverting to an 'investor pays' model: "There's a free rider problem with subscriber-funded ratings, and most would agree that ratings should be freely available, particularly if they are referenced in regulations."[155]

Yet, in a HFS hearing on 21 October 2008, Alice Rivlin, the founding director of the Congressional Budget Office, proposed that:

> We should find a way to have rating agencies paid by the buyers of securities instead. This suggestion is often scorned by economists, who say it poses a "free rider" problem, but I think that could be handled by requiring that all investment funds over a certain size pay a small percentage fee to support the services of rating agencies.[156]

However, Raymond McDaniel pointed to similar conflicts of interests in the 'investor pays' model:

> With respect to issuer- versus investor-pay model, I think the biggest mistake we could make is believing that an investor-pay model does not embed conflict of interests. So long as rating agencies are paid by any party with a financial stake in the outcome of

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[153] Chairman Christopher Cox and Representative John Yarmuth, US House Committee on Oversight and Government Reform, Hearing on the role of Federal Regulators and the Financial Crisis, 23 October 2008

[154] Opening Statement of Chairman Henry Waxman, US House Committee on Oversight and Government Reform, Hearing on the Credit Ratings Agencies and the Financial Crisis, 22 October 2008

[155] Ibid., Jerome Fons

[156] Testimony of Alice Rivlin, Hearing on The Future of Financial Services Regulation, House Committee on Financial Services, 21 October 2008

> our opinions – and that includes investors and issuers – there are going to be pressures.
>
> And so the question is not are there conflicts of interest. There are. It's managing them properly and managing them with enough transparency that regulatory authorities and market participants can conclude that, in fact, those conflicts are being handled to the right professional standard.[157]

Economist Joseph Stiglitz recommended that Congress create a government rating agency to recognise that accurate ratings are a public good – something that is in the interest of the public at large, but which may not be effectively provided by the private sector.[158]

3.5 Hedge funds

Hedge funds are generally advanced investment vehicles leveraged by monies provided by a small group of rich investors who seek to share large returns in exchange for paying management fees. Due to their limited regulation, hedge funds are permitted considerable freedom in the financial activities that they may undertake.

In a hearing on 13 November 2008 at the HCO, then-Chairman Waxman provided an overview of the hedge fund regulatory status quo:

> Currently, hedge funds are virtually unregulated. They are not required to report information on their holdings, their leverage, or their strategies. Regulators aren't even certain how many hedge funds exist and how much money they control. We do know, however, that hedge funds are growing rapidly and becoming increasingly important players in the financial markets. Over the last decade, their holdings reportedly have increased over five-fold, to more than $2 trillion. We also know that some hedge funds are highly leveraged. They invest in assets that are illiquid and difficult to price, and sell rapidly.[159]

Ranking Member Tom Davis argued that hedge funds have become systemically important, departing from their original small-scale investment purpose:

> It wasn't supposed to be this way. Billed as purely private gambles by sophisticated investors, hedge funds now pose very public peril when the bets go bad. Designed as a strategy to reduce investment risk, hedge funds now compound risk when complex deals start to unravel and throw off unintended consequences. Empowered by sophisticated computer models, hedge fund trading was meant to capitalize on, not cause, global market shifts. But now, due to their size and speed, hedge funds often accelerate wild market fluctuations.[160]

Given that hedge funds have become an important influence on public outcomes – estimated to account for 20-30% of trading volume in US stocks, and widely backed by pension funds and other institutional investors – Davis explained that regulation is necessary. Democrat

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[157] Raymond McDaniel, US House Committee on Oversight and Government Reform, Hearing on the Credit Ratings Agencies and the Financial Crisis, 22 October 2008

[158] Joseph Stiglitz, Hearing on The Future of Financial Services Regulation, House Committee on Financial Services, 21 October 2008

[159] Chairman Henry Waxman, House Committee on Oversight and Government Reform, Hearing on Hedge Funds and the Financial Markets, 13 November 2008

[160] Ibid., Ranking Member Tom Davis

Representative Carolyn Maloney endorsed this perspective, arguing that hedge funds accentuate downturns by selling a variety of assets (and hence lowering prices further) as their investors seek to redeem their investments.[161] Furthermore, Davis argued that regulation could help the industry “mature and survive”, as well as protect the many members of the public who are indirectly invested in their performance. However, Republican Representative Darrell Issa suggested that given hedge funds are generally invested both short and long the impact of unwinding their investments may actually be relatively price neutral.[162]

Professor David Ruder expanded on the need for more transparency, suggesting that the SEC should be granted the power to investigate hedge funds and hedge fund advisors – powers it was denied in a legal case in 2004. While Ruder explained that such regulation could reduce fears of counterparty risk arising from market uncertainty regarding the possibility of default, he emphasised that regulation should not be so strict as to impede the innovative potential of hedge funds:

> It should have power to require hedge fund advisers to disclose the size and nature of hedge fund risk positions and the identities of their counterparties. It should have the power to monitor and assess the effectiveness of hedge fund risk-management systems. Information the SEC receives should be shared by a confidential basis with the Federal Reserve Board as the federal agency with primary responsibility for systemic risk regulation.
>
> Although these new regulatory powers are important, it is not desirable to impose regulation on hedge fund risk activities, including use of leverage and derivative instruments. Hedge funds should not be regulated in a matter that stifles their innovative financial market activities.[163]

All five of the hedge fund managers testifying at the hearing agreed that some level of confidential disclosure was necessary. Expanding upon this suggestion, President of hedge fund Renaissance Technologies, Jim Simons, proposed regulation

> … requiring all market participants to report their positions to an appropriate regulator and then allowing the New York Fed to have access to aggregate position information and to recommend action, if necessary.[164]

Although the committee consensus was that regulations should apply to the largest hedge funds, Democrat Representative Paul Sarbanes instead proposed that disclosure should be determined by the type of investment.[165]

However, increased transparency was not supported by all. Financial expert Houman Shadab argued that greater information disclosures may induce a false sense of financial security:

> … when that type of information is created by regulators, it creates a false sense of security among market participants that these risks are adequately being monitored and managed. And in fact to a large extent, the reason the investment banks took on so much leverage and collapsed was because market participants were under the false assumption that the Securities and Exchange Commission, through their consolidated

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161 Ibid., Representative Carolyn Maloney
162 Ibid., Representative Darrell Issa
163 Ibid., David Ruder
164 Ibid., Jim Simons
165 Ibid., Representative Paul Sarbanes

> supervised entities program, was monitoring the risk of investment banks to their investors and to the economy. But it was not doing so.[166]

Kenneth Griffin, head of the hedge fund Citadel Group, told the committee that *full public transparency* would be "parallel to asking Coca-Cola to disclose their secret formula to the world."[167] George Soros, who often disagreed with the perspectives of his fellow hedge fund managers, stated that:

> Excessive deregulation is at the root of the current crisis. And there's a real danger that the pendulum will swing too far the other way. That would be unfortunate because regulations are liable to be even more deficient than the market mechanism itself.[168]

Hedge fund leverage also received significant attention. John Paulson, head of the Paulson & Co fund, endorsed the imposition of more stringent capital requirements, stating:

> I think that the equity requirements for financial institutions need to be raised and the margin requirements, the amount of capital institutions or investors have to hold to support individual securities, should also be raised.[169]

Paulson also suggested that margin requirements – the percentage of an asset's value that may be used as collateral to finance its purchase – be raised on certain types of asset. Four of the five hedge fund managers testifying agreed on the general need for reductions in financial leverage, although they did point out that hedge funds have often been less leveraged than banks.

Professor Andrew Lo suggested that financial problems had been exacerbated by competition with banks that had increasingly behaved like hedge funds:

> … while hedge funds have taken on many of the same functions as banks over the last decade, banks to the repeal of the Glass-Steagall Act in 1999, many banks have now become more like hedge funds. And over the past decade, commercial banks, investment banks, and hedge funds have been locked in heated competition with each other all fuelled by investors, including pension funds, sovereign wealth funds, and government-sponsored enterprises seeking that extra bit of yield in a frustratingly low yield environment.
>
> This economic free-for-all between banks, hedge funds, government-sponsored entities, and Wall Street is one of the main reasons for the magnitude of the current financial crisis.[170]

Waxman and Democrat Representative Elijah Cummings criticised the low rate of tax paid by hedge fund investors. Cummings identified that, despite the five hedge fund managers present at the panel earning an average of over $1bn in the preceding year, they may only

[166] Ibid., Houman Shadab
[167] Ibid., Kenneth Griffin
[168] Ibid., George Soros
[169] Ibid., John Paulson
[170] Ibid., Andrew Lo

face capital gains tax rates as low as 15% on much of their income – "a lower tax rate than many school teachers, firefighters, or even plumbers pay."[171]

However, this remains controversial: Representative Issa, for example, argued that the lower rate is justified through the long-term gain added to the economy and for the risk an individual undertakes in ownership as opposed to employment:

> ISSA: … Isn't it true that if a doctor forms a medical practice and builds it up and then sells it, he gets capital gains treatment on that?
>
> BANKMAN: That's right.
>
> ISSA: OK. So the doctor really does have the same opportunity. He just has to avail himself of it. He works for a hospital and he doesn't own a piece of the clinic or hospital, then he doesn't avail himself. If he does invest in that in some sort of partnership, he gets that ability when it's sold.[172]

John Paulson added that if

> … one of yours constituents, whether they're a plumber or a teacher, bought a stock and held that stock for more than a year, they would pay a long-term rate of capital gains tax.[173]

Furthermore, as Representatives Cummings noted, the House twice passed legislation restricting the applicability of the 15% rate, only for it to have failed in the Senate.[174]

Philip Falcone and Kenneth Griffin both argued that any move to tax long-term capital gains from hedge funds at the ordinary earned income tax rate should also apply to similar private investment vehicles such as private equity. Falcone stated that:

> But I think it is important not to differentiate between hedge funds and the rest of the investment community, whether in a private equity or real estate or even individuals or the doctor that may own his hospital and decide to sell it.[175]

3.6 Derivative markets

Financial derivatives – a contract whose value is derived from another asset – can be used by firms to reduce their risk exposure, but also as a method of making speculative bets. Of particular prominence among derivatives have been credit default swaps (CDSs). With 80-90% of the CDS market based on speculative bets,[176] its notional value[177] soared to $62tr by December 2007.[178] Under an exemption passed in 2000, CDSs do not fall under the authority of the Commodity Futures Trading Commission (CFTC) or the SEC. Accordingly, they are not regulated by any regulatory agency. The financial system has many linkages with derivative markets which have contributed to the pervasive nature of recent damage to the financial system's stability. Democrat Senator Blanche Lincoln has suggested that:

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[171] Ibid., Representative Elijah Cummings
[172] Ibid., Representative Darrell Issa
[173] Ibid., John Paulson
[174] Ibid., Representative Elijah Cummings
[175] Ibid., Philip Falcone
[176] Testimony of Eric Dinallo, Senate Committee on Agriculture, Nutrition and Forestry, Hearing on The Role of Financial Derivatives in the Current Financial Crisis, 14 October 2008
[177] Notional value is defined as the sum that protection sellers would owe protection buyers were all underlying credit entities defaulted and the value of their debt went to zero.
[178] **2007 Year-End Market Survey**, International Swaps and Derivatives Association

> … outside of Wall Street – we look at the regulatory bodies of the CFTC and the SEC and the staff of this committee and others – few people knew about derivatives or credit default swaps.[179]

Chairman of the Senate Committee on Agriculture, Nutrition and Forestry (the committee overseeing the CFTC), Tom Harkin, argued that this lack of regulation led to a situation where "tools to manage and limit risk have turned out to magnify and amplify risk."[180] Superintendent for the State of New York Insurance Department, Eric Dinallo, added:

> And what's interesting is that it wasn't, you know, insider trading, or late trading or off-balance-sheet transactions that hurt us. It wasn't, you know, firm regulation or soft regulation, or strong enforcement or lax enforcement that apparently helped to blow up the global economy. It's what we chose not to regulate.
>
> (…)
>
> So if you tell them everything over here is unregulated, they're going to kind of reproduce their activity in the more inexpensive, less capital-intensive way in unregulated areas. And credit default swaps and other derivatives brilliantly permit them to do that, and that's, I think to a large extent, what this is about.[181]

William Black, an academic at the University of Missouri, identified that "banks did credit default swaps primarily so that they could increase their leverage by taking things off of their balance sheet and reducing greatly their capital requirements", but also as a means of selling stocks short without being encumbered by the regulations of an exchange.[182]

A number of Senators including Chairman Harkin cited greed as the problem underlying the situation:

> Well, as I said, we've got to have regulations to protect our economy from these excesses. It's like Franklin Roosevelt said when he first came to office. He said, "You know, we always knew that greed was bad morals. We now know it's bad economics." It was true then, and it's true today.
>
> So in my mind, there is no question that we must adopt a stronger system of regulation and oversight for these swaps and derivatives and everything else that's out there.[183]

Alice Rivlin, testifying at an earlier hearing by the HCFS, defined the problem and explained that:

> The question is: should we clamp down on the leverage or on the products themselves? I incline to think that we will be more successful if we operate on the leverage by imposing higher capital requirements on all financial institutions that have any claim on federal help if they are in danger of failing. We should also improve the transparency of derivatives, but I doubt it would be useful to screen classes of

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179 Senator Blanche Lincoln, Senate Committee on Agriculture, Nutrition and Forestry, Hearing on the Role of Financial Derivatives in Current Financial Crisis, 14 October 2008

180 Chairman Tom Harkin, Senate Committee on Agriculture, Nutrition and Forestry, Hearing on the Role of Financial Derivatives in Current Financial Crisis, 14 October 2008

181 Ibid., Eric Dinallo

182 Ibid., William Black

183 Ibid., Chairman Harkin

> derivatives before allowing their sale. Charging a regulator with the task of weighing the risk-spreading value of a class of complex derivatives against the risk posed by the complexity itself strikes me as too hard to pull off.[184]

A widely supported response was the introduction of a centralised clearing house. Citing then-acting chairman of the CFTC Walt Lukken's letter to the Wall Street Journal,[185] Republican Senator Richard Lugar identified that:

> Clearinghouses have been around almost as long as trading itself as a means for mitigating the risks associated with exchange-traded financial products. Whether securities, options, or futures, centralized clearinghouses ensure that every buyer has a guaranteed seller and every seller has a guaranteed buyer, thus minimizing the risk that one counterparty's default will cause a systemic ripple through the markets. The clearinghouse is able to take on this role because it is backed by the collective funds of its clearing members.[186]

Superintendent Dinallo specified that:

> … it would be optimal to have a central counterparty, so you have strong capital behind those bets. You have a very capitalized, very robust central counterparty that has a guarantee fund and the earmarks of sort of a solvency or capital regime.[187]

Ananda Radhakrishnan, director of the division of clearing and intermediary oversight for the CFTC, added that in addition to centralising default risk in a central counterparty, such a move would make clearer the level of exposure that every participant is undertaking.[188]

The creation of a regulated derivatives market with a central clearing house also received support from successful hedge fund managers. Philip Falcone said that an "open and transparent market for these transactions would reduce confusion and improve understanding, as well as help with valuation issues",[189] while Kenneth Griffin added that:

> Of greatest importance, such a clearing house will dramatically reduce systematic risk, allowing us to step away from the too-interconnected-to-fail paradigm. Numerous other benefits will accrue to our economy. Regulators, for example, will have far greater transparency into this vast and important market.[190]

Maurice Greenberg, CEO of AIG until 2005, also testified in support of a central exchange with regulatory capital requirements.[191]

However, William Black argued that a clearing house is necessary but not sufficient to prevent asset bubbles because it would not by itself identify fraud or overvaluation. Chairman Harkin questioned whether a regulated exchange would be more effective than a clearing

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[184] Testimony of Alice Rivlin, Hearing on The Future of Financial Services Regulation, House Committee on Financial Services, 21 October 2008

[185] Walt Lukken, How to Solve the Derivatives Problem, Wall Street Journal, 10 October 2008

[186] Senator Richard Lugar, Senate Committee on Agriculture, Nutrition and Forestry, Hearing on the Role of Financial Derivatives in Current Financial Crisis, 14 October 2008

[187] Ibid., Eric Dinallo

[188] Ibid,. Ananda Radhakrishnan

[189] Philip Falcone, House Committee on Oversight and Government Reform, Hearing on Hedge Funds and the Financial Markets, 13 November 2008

[190] Ibid., Kenneth Griffin

[191] Maurice Greenberg, US House Committee on Oversight and Government Reform, Hearing on AIG, 2 April 2009

house – Ananda Radhakrishnan replied that an exchange "enhances price transparency, liquidity and order processing, and you have the benefit of a centralized counterparty", although it would lose the flexibility of customised transactions.[192] Robert Pickel, CEO of the International Swaps and Derivatives Association, added that a key component of the derivatives market is customised contracts – a flexibility that would be lost on a more restrictive regulated exchange.[193] However, Terrence Duffy, executive chairman of clearing house CME Group, suggested that his institution could accommodate this feature.[194] Jonathan Short, general counsel for the Intercontinental Exchange, explained: "I don't think it's a requirement that something be executed on an exchange" in order to go through a central counterparty and increase transparency.[195]

Hedge fund manager George Soros more radically suggested that some instruments should not be allowed if the regulators do not understand them and their leverage cannot be calculated:

> So given all the derivatives that have been introduced, calculating the leverage becomes a very, very complicated problem. And especially if you have tailor-made instruments, then it becomes even more difficult.
>
> So I think that it's certainly necessarily for the regulators to understand what they are regulating. And if they don't, they should perhaps not allow some of those instruments to be used. So I think that the instruments themselves would have to be authorized, approved by the SEC or whatever, before they could be used.[196]

Chairman Harkin went even further by suggesting that some derivatives – especially speculative CDSs, which are essentially speculative bets – are not necessary to the functioning of the economy:

> In my reading of the history of some of these, it's not that there was a need out there for any of these. It's just that some financial geniuses conjured up collateralized mortgage obligations, or collateralized debt obligations or credit default swaps. We never had credit default swaps before [the] early 1990s. I mean, my wife and I bought a house back in the '70s. We were fine, you know. We had a fixed-rate mortgage.
>
> So why didn't the world fall apart before the 1990s, before we had credit default swaps, you see? So I keep coming back to this, and I know some people say, "Well, that's not the whole problem." Well, maybe not the whole problem, but it's a big part of it right now. So maybe we ought to at least, you know, ban these naked [or purely speculative] credit default swaps, where it's just a bet between two companies, or, again, as I say, put them on a regulated exchange so we know who you are, how much you're doing.[197]

However, Richard Lindsey, CEO of the Callcott Group, warned against cutting out a significant part of the derivatives market. As with futures contracts used to hedge positions, in farming for example, the use of CDSs and other similar instruments are "what drives part

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[192] Ibid., Ananda Radhakrishnan

[193] Ibid., Robert Pickel

[194] Ibid., Terrence Duffy

[195] Ibid., Jonathan Short

[196] George Soros, House Committee on Oversight and Government Reform, Hearing on Hedge Funds and the Financial Markets, 13 November 2008

[197] Senator Tom Harkin, Senate Committee on Agriculture, Nutrition and Forestry, Hearing on the Role of Financial Derivatives in Current Financial Crisis, 14 October 2008

of the price transparency and part of the ability to see where prices are going with agricultural futures."[198]

Another issue was the international dimension. Senator Lugar asked,

> … given electronic transfer of international banking systems generally, why are we likely to see reform in our situation here inhibit anybody from moving off if they have nefarious purposes, or at least maybe they feel their perfectly legitimate purposes, that they like markets without limits, and they can find them somewhere else?[199]

Robert Pickel concurred, and stated that:

> They are traded globally. The parties who are most active in these markets are global parties. They're active in many different jurisdictions. And therefore, I think that whatever the solutions may be, they do need to be discussed here in Congress, but also at that international level as well.[200]

The necessity of international coordination was echoed by the other witnesses.

Christopher Cox suggested that the committee structure in Congress had impeded reform efforts:

> Legislative jurisdiction is split so that banking, insurance and securities fall within the province of the House Financial Services Committee, and the Senate Banking Committee, while futures fall under the Agriculture Committees in both the House and the Senate. This long-running turf battle is one of the reasons that credit default swaps aren't regulated.[201]

4 Federal regulation

In response to the financial crisis, the role of the federal regulators expanded significantly. Chairman of the SCB, Chris Dodd, notes that

> … these decisions have made the American taxpayer a guarantor, owner and shareholder in the financial sector of our economy, to a degree never before seen in our nation's history, and rarely seen in any free market economy.[202]

However, federal regulators have long played an important role in overseeing the financial markets, and helping Congress to devise regulations to ensure their effective functioning.

4.1 Appraising the federal regulators

The regulatory bodies failed to detect risks to the system as systemically important institutions substantially increased their on and off balance sheet borrowing. Exacerbating this problem was the rise of the unregulated 'shadow' banking sector and the increasing complexity of financial products. This significantly decreased the level of transparency in the system, and made it very difficult for even the best-informed regulators to know where risk – that was assumed to lie across a diverse range of institutions – *actually* lay.

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198 Ibid., Richard Lindsey
199 Ibid., Senator Richard Lugar
200 Ibid., Robert Pickel
201 Chairman Christopher Cox, US House Committee on Oversight and Government Reform, Hearing on the role of Federal Regulators and the Financial Crisis, 23 October 2008
202 Chairman Chris Dodd, US Senate Committee on Banking, Housing and Urban Affairs, Hearing on US Credit Markets: Examining Recent Regulatory Responses, 23 October 2008

Treasury Secretary Henry Paulson described the regulatory structure as "hopelessly failed and outmoded and outdated".[203] In a HCO hearing examining the role of the regulators, then-Chairman Waxman stated: "The list of regulatory mistakes and misjudgements is long, and the cost to taxpayers and our economy is staggering." Summarising the situation, Waxman added:

> Over and over again, ideology trumped governance. Our regulators became enablers rather than enforcers. Their trust in the wisdom of the markets was infinite. The mantra became government regulation is wrong, the market is infallible.[204]

Ranking Member on the HCO, Tom Davis, challenged this synopsis and instead argued that regulations and regulators had been slow to respond to an innovative free market:

> It wasn't deregulation that allowed this crisis. It was the mishmash of regulations and regulators, each with too narrow a view of increasingly integrated national and global markets. The words "regulation" and "deregulation" are not absolute goods and evils, nor are they meaningful policy prescriptions.
>
> (…)
>
> Free markets are constantly evolving and innovating. Regulators by law, bureaucratic custom or just bad habit tend to remain static. Modernization to Federal regulatory structures have to take account of the new global dynamics to restore the transparency, confidence and critical checks and balances necessary to sustain us as a great economic power.[205]

Republican Representative William Sali argued that the regulators were inadequately informed and despite possessing the requisite tools, failed to address problems in the financial markets:

> If we didn't get the job done with enough authority to get it done, how will giving more regulators more power do anything different when each of you said you weren't even aware of all the things that Mr. Mica pointed out that were a tremendous problem?[206]

Waxman also sought to quash claims that the regulators were not able to effectively predict problems in the financial markets:

> The truth of the matter is that there were a lot of warning signs, and we have a large staff in some of these agencies. For example, the Federal Reserve has one of the finest economic research staffs in the United States, including a staff of 450, about half of whom are Ph.D. economists.
>
> The reasons why we set up your agencies and gave you budget authority to hire people is so that you can see problems developing before they become a financial

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203 Secretary Henry Paulson, US Senate Committee on Banking, Housing and Urban Affairs, Hearing on US Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions, 23 September 2008

204 Opening Statement of Chairman Henry Waxman, US House Committee on Oversight and Government Reform, Hearing on the role of Federal Regulators and the Financial Crisis, 23 October 2008

205 Opening Statement of Ranking Member Tom Davis, US House Committee on Oversight and Government Reform, Hearing on the role of Federal Regulators and the Financial Crisis, 23 October 2008

206 Ibid., Representative William Sali

> crisis. To tell us afterwards, when we are now faced with the disaster that we're seeing, that you couldn't have foreseen it just doesn't satisfy me.[207]

The Fed – under the leadership of Chairman Alan Greenspan – was criticised by many for facilitating the housing bubble, and refusing to utilise its authority to prevent irresponsible lending. According to economist John Taylor, the low interest rates which underpinned the housing boom were in part driven by an acceptance of a new economic paradigm that justified the Fed's decision to keep interest rates lower than in similar previous scenarios.[208] The policy of continuing low interest rates led economist Paul Krugman, cited by Chairman Waxman,[209] to conclude:

> If anyone is to blame for the current situation, it's Mr. Greenspan, who pooh-poohed warnings about an emerging bubble and did nothing to crack down on irresponsible lending.[210]

Democrat Representative Dennis Kucinich questioned Greenspan's role in presiding over a large increase in household debt:

> But under your term as head of the Fed, public and private debt exploded from 10.5 trillion to $43 trillion. Yet as documented by Jim Oleske in his book called "Yeah, Right," you, Mr. Greenspan, promoted adjustable-rate mortgages that fuelled the subprime market.
>
> (…)
>
> Now, Mr. Greenspan, before the collapse of the housing bubble, didn't you also say that the U.S. has not experienced housing slumps to justify your policy that there would be no bubble?[211]

Democrat Representative John Tierney pointed out that legislation passed in 1994 should have mandated the Fed to prevent "unfair and deceptive" lending. Furthermore, the House consistently pressed for action on this issue. Tierney said:

> You know, the debate between your office and Congress was over in 1994, the Congress passed a law telling your board and you to actually do something about it, and it wasn't done.[212]

Greenspan himself acknowledged the partial failure of his economic worldview:

> I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms. And it's been my experience, having worked both as a regulator for 18 years and similar quantities in the private sector especially, 10 years at a major international bank, that the loan officers of those institutions knew

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[207] Ibid., Chairman Henry Waxman

[208] John B. Taylor, The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong, November 2008

[209] Chairman Henry Waxman, US House Committee on Oversight and Government Reform, Hearing on the role of Federal Regulators and the Financial Crisis, 23 October 2008

[210] Paul Krugman, Busting Bubble Blues, 30 October 2006

[211] Representative Dennis Kucinich, US House Committee on Oversight and Government Reform, Hearing on the role of Federal Regulators and the Financial Crisis, 23 October 2008

[212] Ibid., Representative John Tierney

> far more about the risks involved and the people to whom they lent money than I saw even our best regulators at the fed capable of doing.
>
> So the problem here is something which looked to be a very solid edifice and, indeed, a critical pillar to market competition and free markets did break down. And I think that, as I said, shocked me. I still do not fully understand why it happened. And obviously to the extent that I figure out where it happened and why I will change my views. And if the facts change, I will change.[213]

In an exchange with Chairman Waxman, Greenspan agreed that his ideology may need to change:

> WAXMAN: You found a flaw in the reality...
>
> GREENSPAN: A flaw in the model that I perceived is the critical functioning structure that defines how the world works, so to speak.
>
> WAXMAN: In other words, you found that your view of the world, your ideology was not right, it was not working.
>
> GREENSPAN: Absolutely, precisely. You know, that's precisely the reason I was shocked because I have been going for 40 years or more with very considerable evidence that it was working exceptionally well.[214]

However, Greenspan argued that he was simply implementing the “will” of Congress – something which Waxman disputes:

> GREENSPAN: … But just quickly to say that the overall view that I take of regulation is that I took a pledge when I took an oath of office – when I became Federal Reserve chairman. And I recognized that I did is I said that I am here to uphold the laws of the land passed by the Congress, not my own predilections. And I think you will find that my history is that I voted for virtually every regulatory action that the Federal Reserve Board moved forward on. Indeed, I voted with the majority at all times. And I was doing so because I perceived that that was the will of the Congress. And, in fact, if you go back and look at the record, I felt required by my oath of office to adhere to what I am supposed to do, not what I'd like to do. And that is my history. And I think the evidence very strongly supports that.
>
> WAXMAN: Well, I appreciate that. On the other hand, you didn't get to vote on regulations that you didn't put before the Federal Reserve Board, even though you had the legal authority for those regulations.[215]

The regulatory structure received significant criticism for failing to integrate different regulators or provide an overview of the financial system. Then-Chairman of the SEC, Christopher Cox, was particularly vocal in this area, arguing that it became very difficult for regulators to make reasonable systemic evaluations:

> But what we're seeing is different parts of the elephant. We're trying to integrate that as closely as we can. Coordination is complicated by the fact that, first, the agencies themselves administer different laws and govern economically similar products in different ways.

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[213] Ibid., Alan Greenspan

[214] Ibid., Chairman Henry Waxman and Alan Greenspan

[215] Ibid.

> Second, their jurisdiction comes to an abrupt stop and sometimes the next regulatory agency doesn't pick up where that leaves off. And one of the most significant regulatory gaps is the one to which several of you have alluded to here this morning, and that is the gap in the 2000 CFMA [Commodity Futures Modernization Act] that left completely unregulated – it leaves open today as we meet here – the $58 trillion notional market in credit default swaps.[216]

Former Treasury Secretary John Snow added that: “It's like the blind man and the elephant. They're all touching a piece of it, but they don't know what the big picture is.”[217]

The SEC suffered from a lack of scope, but also from a disinclination to employ strict regulations. The SEC, which had the power to regulate the CRAs, failed to do so effectively despite encouragement from Congress that culminated in the Credit Rating Agency Reform Act of 2005. Moreover, the SEC presided over the relaxation of capital requirements[218] – Cox highlighted this as one of the things he would have done differently, in retrospect, as head of the SEC:

> I would have wanted to question its reliance on the widely used Basel standards for commercial banks and the Federal Reserve's 10 percent well-capitalized standard for bank holding companies. Those standards, as we have seen, proved insufficient for commercial banks as well.[219]

Democrat Representative Elijah Cummings strongly criticised Chairman Cox for failing to respond to the derivatives situation:

> In March 2005, a few months before you became SEC chairman, the Financial Engineering News reported that the SEC had assembled, quote, "people from each SEC division," end of quote, corporation finance, enforcement, market regulation and investment management to look at issues relating to the derivatives market and the implication of the growth of credit derivatives. What happened to that task force under your leadership?
>
> (…)
>
> … [Your staff] said we have been told by former SEC staff that you failed to support the work of the task force. In fact, you've basically defunded the whole office of risk assessment that had been assembled for the task force.[220]

Congress, as Waxman asserted, “is not exempt from responsibility.”[221] First, Congress received criticism for its failures concerning Fannie and Freddie. Representative Davis argued that Congress encouraged increasingly risky lending by the mortgage brokers:

> Out of well intentioned zeal to promote homeownership, members from both parties and both chambers not only tolerated, but encouraged the steady erosion of mortgage lending standards.[222]

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216 Ibid., Chairman Christopher Cox
217 Ibid., John Snow
218 Ibid., Opening Statement of Chairman Henry Waxman
219 Ibid., Chairman Christopher Cox
220 Ibid., Representative Elijah Cummings
221 Ibid., Opening Statement of Chairman Henry Waxman

Republican Representative John Mica cited an article by former CEO of Fannie Mae, Franklin Raines, which appeared in the *New York Times* in 1999:

> In moving even tentatively into this new area of lending, Fannie Mae is taking on significantly more risk, which may not pose any difficulty during flush economic times but the government subsidized corporation may run into trouble in an economic downturn, prompting a government rescue similar to that of the Savings and Loan Association.[223]

In addition, Congress was accused of failing to permit effective oversight of the mortgage giants.[224] Second, as explained above, Congress allowed President Clinton to pass legislation permitting derivatives such as CDSs to be traded without regulation.

4.2 Proposed changes to the regulatory framework

On 21 October 2008, the HCFS held a hearing to examine the future of financial regulation. Democrat Representative Paul Kanjorski was particularly vociferous in his calls for change, stating that "we must recognize that regulation is needed to prevent systemic collapse".[225] Former Treasury Secretary John Snow argued:

> We have a fractured regulatory system, one in which no single regulator has a clear view, a 360-degree view of the risks inherent in the system. We need to change that. We need to move to a 360-degree view regulatory system.[226]

The importance of new regulation was also highlighted by Joseph Stiglitz, who said: "We are giving a massive blood transfusion to a patient who is haemorrhaging from internal bleeding - but we are doing almost nothing to stop that internal bleeding."[227]

Following the Congressional hearings described in this paper, the Treasury published a paper outlining its plans for reforming financial regulation in June 2009. A summary of the proposed reforms – which also includes the recommendations made by British, European and international authorities – is contained in the Library Standard Note *Proposals to reform financial regulation*.[228]

The mortgage market

Alice Rivlin, founding director of the Congressional Budget Office, argued that blame for the mortgage market problems should apply nationwide, not just to Wall Street:

> We have been spending too much, saving too little, and borrowing without concern for the future from whomever would support our over-consumption habit –the mortgage company, the new credit card, or the Chinese government. We indulged ourselves in the collective delusion that housing prices would continue to rise. The collective delusion affected the judgment of buyers and sellers, lenders and borrowers, builders and developers. For a while the collective delusion proved a self-fulfilling prophecy –

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222 Representative Tom Davis, US House Committee on Oversight and Government Reform, Hearing on causes and effects of the Lehman Brothers bankruptcy, 6 October 2008

223 Ibid., Representative John Mica

224 Opening Statement of Chairman Henry Waxman, US House Committee on Oversight and Government Reform, Hearing on the role of Federal Regulators and the Financial Crisis, 23 October 2008

225 Representative Paul Kanjorski, Hearing on The Future of Financial Services Regulation, House Committee on Financial Services, 21 October 2008

226 Testimony of John Snow, US House Committee on Oversight and Government Reform, Hearing on the role of Federal Regulators and the Financial Crisis, 23 October 2008

227 Testimony of Joseph Stiglitz, Hearing on The Future of Financial Services Regulation, House Committee on Financial Services, 21 October 2008

228 House of Commons Library, Proposals to reform financial regulation, SN/BT/05100, 22 June 2009

> house prices kept rising and all the building and the borrowing looked justifiable and profitable. Then, like all bubbles, it collapsed as housing prices leveled off and started down.[229]

In seeking to rectify problems in the mortgage market, Rivlin recommended "minimum down payments, proof of ability to repay, and evidence that the borrower understands the terms of the loan". She added: "I would get rid of teaser rates, penalties for pre-payment, and interest-only mortgages".[230] Rivlin also suggested that higher commission granted to mortgage brokers receiving higher rates of interest – that is, from riskier clients – should be reassessed.

In order to prevent the moral hazard arising from the ability of mortgage lenders to sell on their loans, economist Stiglitz proposed that mortgage lenders retain "at least a 20% equity share" in the mortgage.[231] This analysis received support from former Fed Chairman Alan Greenspan, when testifying at an earlier hearing:

> As much as I would have preferred otherwise, in this financial environment I see no choice but to require that all securitizers retain a meaningful part of the securities they issue. This will offset, in part, market deficiencies stemming from the failures of counterparty surveillance.[232]

Furthermore, Stiglitz proposed that

> … variable rate mortgages in which payments can vary significantly (as opposed to variations in maturity) should be forbidden, at least for all individuals whose income is below a certain threshold.[233]

The management of asset bubbles more generally proved to be an important consideration for future regulation, given that no regulator has explicit authority to address the issue. However, Stiglitz pointed out that problems arise from the multiple objectives institutions like the Fed are seeking to address:

> While it is not realistic to expect the Fed to pursue several objectives simultaneously with the one blunt instrument (the federal funds rate), we certainly need to be more creative about curbing asset bubbles. Maybe we have to invent another instrument specifically aimed at slowing asset bubbles.[234]

Banking regulation

Joseph Stiglitz proposed a sharp division between core financial institutions – such as commercial banks and pension funds – which address the needs of citizens, and those which exist for a subset of the wealthy. Stiglitz suggested that the former should be shielded from their interaction with the latter except in approved cases.[235] Stiglitz also appeared to endorse separating the depository banking institutions from investment banks:

> The fact that two investment banks have converted themselves into bank holding companies should be a source of worry. They argued that this would provide them a

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[229] Testimony of Alice Rivlin, Hearing on The Future of Financial Services Regulation, House Committee on Financial Services, 21 October 2008

[230] Ibid.

[231] Ibid., Joseph Stiglitz

[232] Testimony of Alan Greenspan, US House Committee on Oversight and Government Reform, Hearing on the role of Federal Regulators and the Financial Crisis, 23 October 2008

[233] Testimony of Joseph Stiglitz, Hearing on The Future of Financial Services Regulation, House Committee on Financial Services, 21 October 2008

[234] Ibid.

[235] Ibid.

> more stable source of finance. But they should not be able to use insured deposits to finance their risky activities. Evidently, they thought they could. It means that either prudential regulation of commercial banks has been so weakened that there is little difference between the two or that they believe that they can use depositor funds in their riskier activities. Neither interpretation is comforting.[236]

More controversially, Democrat Congresswoman Carolyn Maloney strongly criticised the repeal of Glass-Steagall in 2004 – an act that had separated the risky investment activities of financial institutions from typical safe banking activity.[237] However, the academic and business panel testifying at the HCO remained divided on the need to return to such separation: pushed for a simple yes or no answer, two of the five panellists said that they believed that repealing Glass-Steagall was a mistake.

Paul Volcker, former Chairman of the Fed and current head of President Obama's Economic Recovery Advisory Board, addressed this issue in March 2009 at a conference at New York University. Volcker argued that reinstating some of the divisions under Glass-Steagall would be important to the future stability of the financial sector in the US because:

> What used to be the traditional investment banks, Morgan Stanley, Goldman Sachs so forth, which used to do some underwriting and mergers and acquisitions, are dominated by other activities we would exclude – very heavy proprietary trading, hedge funds.

The imposition of stricter capital requirements has been widely supported. However, Stiglitz warned that capital adequacy requirements must be carefully designed:

> Commercial banks and similar institutions have to have adequate capital and provisioning of risks. But capital adequacy rules have to be carefully designed. Capital adequacy standards/provisions (reserves) have to be designed to be countercyclical. Otherwise, there is a risk that they will contribute to cyclical fluctuations. The decrease of asset values in a downturn can force cutbacks in lending, exacerbating the downturn; and in the boom, the asset price increases allow more lending. On both sides, cyclical fluctuations are amplified.
>
> Many, looking for simple and simplistic rules, hoped that capital adequacy requirements would be all that was required-a minimal intervention in the market by those believing in free markets but recognizing that free banking has been a disaster everywhere that it has been tried. Capital adequacy standards alone, however, do not suffice; indeed, increasing capital adequacy standards may lead to increased risk taking.[238]

Then-Chairman Cox retrospectively argued for greater disclosure. In particular he pointed to the lack of transparency in the municipal securities market, and proposed that investment banks in particular be required to provide further information;

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[236] Ibid.

[237] Representative Carolyn Maloney, US House Committee on Oversight and Government Reform, Hearing on causes and effects of the Lehman Brothers bankruptcy, 6 October 2008

[238] Testimony of Joseph Stiglitz, Hearing on The Future of Financial Services Regulation, House Committee on Financial Services, 21 October 2008

> Individual investors account for nearly two-thirds of this multi trillion dollar market, and yet neither the SEC, nor any Federal- regulator, has the authority to insist on full disclosure. Most importantly, we have learned that voluntary regulation of financial conglomerates does not work. Neither the SEC nor any regulator has the statutory authority to regulate investment bank holding companies, except on a voluntary basis, and that must be fixed.[239]

Further discussion of banking recommendations is contained in Section three of this paper.

Supporting non-bank financial firms

Chairman of the HCFS, Barney Frank, called for a coherent system dealing with the failure of non-bank financial institutions such as Lehman Brothers and AIG. He said,

> … when non-bank major financial institutions need to be put out of their misery, we need to give somebody the authority to do what the FDIC can do with banks.[240]

Frank added that:

> It allows us to avoid the choice of all or nothing – nothing in the case of Lehman Brothers, all in the case AIG – equally unacceptable alternatives. And our job is to work together to try and find some other way.[241]

Fed Chairman Ben Bernanke agreed, and further suggested that had legislation already been in place a more effective solution for AIG could have been found.

> AIG highlights the urgent need for new resolution procedures for systemically important nonbank financial firms. If a federal agency had had such tools on September 16, they could have been used to put AIG into conservatorship or receivership, unwind it slowly, protect policyholders and impose haircuts on creditors and counterparties, as appropriate. That outcome would have been far preferable to the situation we find ourselves in now.[242]

Treasury Secretary Tim Geithner proposed the introduction of measures to address this problem. In particular, his plan stated:

> The proposed resolution authority would allow the government to provide financial assistance to make loans to an institution, to purchase its obligations or assets, to assume or guarantee its liabilities, and purchase an equity interest. U.S. government as conservator or receiver would have additional powers to sell or transfer the assets or liabilities of the institution in question, to renegotiate or repudiate the institution's

[239] Chairman Christopher Cox, US House Committee on Oversight and Government Reform, Hearing on the role of Federal Regulators and the Financial Crisis, 23 October 2008

[240] Chairman Barney Frank, House Committee on Financial Services, Hearing on Oversight of the Federal Government's Intervention at AIG, 24 March 2009

[241] Ibid.

[242] Ibid., Chairman Ben Bernanke

> contracts, and prevent certain financial contracts with the institution from being terminated on account of conservatorship or receivership.[243]

Accounting

The impact of mark-to-market accounting rules has been seen as one of the contributing factor to the financial crisis. Their suspension or removal – which would allow firms to assign higher values to balance sheet assets such as MBSs, and thereby reduce problems of solvency – was debated at length in Congress and among regulators.

At the SCB hearing on 23 September 2008, Chairman Bernanke proposed a suspension of mark-to-market accounting in order to prevent dramatic asset write-downs. 'Toxic' assets, which had become almost entirely illiquid, could only be sold at 'fire sale' prices. Bernanke argued that these low prices, which had been determined by the market mechanism, may have significantly understated their actual value, and therefore induced excessive write-downs (which in turn required banks to sell more assets or recapitalise in order to meet their capital requirements).[244]

Other witnesses in Congress questioned the use of mark-to-market accounting: Michael Washburn, CEO of Red Mountain Bank, said the rules forced companies to report at "irrational levels";[245] Edward Yingling, CEO of the American Bankers Association, added that the system is "simply incompatible with the banking system as we have come to know it."[246] Martin Sullivan, former CEO of AIG, explained that AIG was

> …forced on mark our [credit default] swap positions at fire sell prices as if we owned the underlying bonds even though we believed that our swap positions had value if held to maturity.[247]

Chairman of the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Representative Paul Kanjorski, criticised the pro-cyclicality[248] of mark-to-market accounting, and demanded an overhaul of procedures that provide for unnecessary distortions that can exacerbate crises:

> The standard does provide transparency for investors, but its strict application in the current environment is, in too many instances, distorting, rather than clarifying, the picture. Take the case of the Federal Home Loan Bank of Atlanta. Last September, the bank estimated that it would lose $44,000 in cash flows on three private label mortgage-backed securities starting in about 15 years. The magic of mark-to-market accounting required this relatively minor shortfall to be treated as an other-than-temporary-impairment loss of $87.3 million. I find that accounting result to be absurd. It

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243 Ibid., Secretary Tim Geithner

244 Chairman Ben Bernanke, US Senate Committee on Banking, Housing and Urban Affairs, Hearing on US Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions, 23 September 2008

245 Michael Washburn, Hearing on The Future of Financial Services Regulation, House Committee on Financial Services, 21 October 2008

246 Ibid., Edward Yingling

247 Martin Sullivan, US House Committee on Oversight and Government Reform, Hearing on the AIG Bailout, 7 October 2008

248 Where a variables, in this case accounting practices, move positively with the economic cycle. Hence, when the cycle is booming, it is postulated that mark-to-market accounting allows firms to report significant profits. When in a downturn, losses are magnified.

> fails to reflect economic reality. We must correct the rules to prevent such gross distortions.[249]

However, Stiglitz suggested that removing mark-to-market accounting could distort the incentives facing banks:

> Not using mark-to-market not only provides opportunities for gaming (selling assets that have increased in value while retaining those that have decreased, so that they are valued at purchase price), but it also provides incentives for excessive risk taking.[250]

On 30 December 2008, the SEC concluded that suspending mark-to-market rules was not justified, although it did propose eight improvements to the standards.[251] However, on 2 April 2009 the Financial Accounting Standards Board voted unanimously to allow banks more discretion in their valuation of toxic assets by moving away from mark-to-market accounting standards.[252] The new regulations will see assets in illiquid markets valued at the price expected to be paid in an 'orderly', as opposed to 'firesale', transaction. Furthermore, the new regulations – to apply from 15 June 2009, with the option of starting on 15 March 2009 – require "disclosures on a quarterly basis, providing qualitative and quantitative information about fair value estimates for all those financial instruments not measured on the balance sheet at fair value."[253]

Corporate governance

Reforms to corporate governance were another popular feature in the wider debate. Chairman Bernanke was critical of the existing structures, arguing that:

> I do think that it's very important that compensation links performance and reward appropriately and, in particular, does so in a way that does not incentivize excessive risk-taking, that makes sure that we don't get short-term compensation for long-term outcomes".[254]

Joseph Stiglitz argued for greater transparency in executive compensation:

> Companies often do not report other aspects of executive compensation in a transparent way and typically do not disclose the extent to which executive compensation is correlated with performance. (Too often, when stock performance is

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249 Representative Paul Kanjorski, US House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Hearing on Mark-to-Market Accounting: Practices and Implications, 12 March 2009

250 Testimony of Joseph Stiglitz, Hearing on The Future of Financial Services Regulation, House Committee on Financial Services, 21 October 2008

251 Congressionally-Mandated Study Says Improve, Do Not Suspend, Fair Value Accounting Standards, SEC, 30 December 2008

252 FASB Issues Final Staff Positions to Improve Guidance and Disclosures on Fair Value Measurements and Impairments, FASB News Release, 9 April 2009; U.S. rulemaker eases mark-to-market's bite, Reuters, 2 April 2009

253 FASB Issues Final Staff Positions to Improve Guidance and Disclosures on Fair Value Measurements and Impairments, FASB News Release, 9 April 2009

254 Chairman Ben Bernanke, House Committee on Financial Services, Hearing on Oversight of the Federal Government's Intervention at AIG, 24 March 2009

> poor, stock options are replaced with other forms of compensation, so that there is in effect little real incentive pay.)[255]

Stiglitz also proposed new compensation guidelines akin to those proposed by the UK Financial Service Authority's Turner Review[256]:

> Bonuses should be based on performance over at least a five year period. If part of compensation is based on shorter term performance, there needs to be strong clawback provisions. Any incentive pay system should not induce excessive risk taking, so that there should be limited asymmetries in the treatment of gains and losses. Any pay system that is claimed to be incentive-based should be demonstrably so. Average compensation and compensation of individual managers should be shown to be related to performance.[257]

More specifically, Stiglitz suggested that stock options, which "provide incentives for bad accounting-of the kind that we have seen-moving activity off balance sheet" need to be made more transparent and curtailed.[258]

Gregory Smith, a manager of a pension fund, argued that Wall Street required new corporate governance rules to align the interests of executives and shareholders:

> We need a regulatory framework that's aligned with the shareholder – not with corporate America, but with the shareholders – and in a regulatory framework that's prepared to hold people accountable that breach their duty to the shareholder.[259]

Former CEO of AIG, Maurice Greenberg, agreed with Representative Kanjorski that companies should be required to increase disclosure requirements for shareholders, as a means of ensuring that they possess sufficient information to challenge the firm's actions.[260]

Regulatory structure

A number of witnesses identified the scattered nature of regulatory bodies as a significant impediment to effective regulation. Steve Bartlett – President and CEO of the Financial Services Roundtable, which represents 100 large financial services firms – argued that the "chaotic system of financial regulation was a contributing factor to the current crisis."[261] Bartlett found mortgage lending to be an area of particular concern:

> The regulation of mortgage finance illustrates these structural flaws. No single regulator was accountable for identifying and recommending corrective actions across the mortgage origination, securitization, and insurance process. Most mortgage brokers were not subject to any licensing and qualification requirements. Over half of all mortgage loans were originated by state-licensed lenders and were not subject to supervision or regulation. Other lenders that were regulated were able to engage in

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[255] Testimony of Joseph Stiglitz, Hearing on The Future of Financial Services Regulation, House Committee on Financial Services, 21 October 2008

[256] Turner Review, FSA, 18 March 2009

[257] Testimony of Joseph Stiglitz, Hearing on The Future of Financial Services Regulation, House Committee on Financial Services, 21 October 2008

[258] Ibid.

[259] Testimony of Gregory Smith, US House Committee on Oversight and Government Reform, Hearing on causes and effects of the Lehman Brothers bankruptcy, 6 October 2008

[260] Maurice Greenberg and Representative Paul Kanjorski, US House Committee on Oversight and Government Reform, Hearing on AIG, 2 April 2009

[261] Steve Bartlett, Hearing on Regulation of Systemic Risk, House Committee on Financial Services, 17 March 2009

> practices that did not meet basic safety and soundness or consumer protection standards.[262]

It was also suggested that firms such as AIG deliberately chose regulators with limited capacities.

Bartlett proposed that the Fed act as a comprehensive "market stability regulator", which "should identify risks and act through and with a firm's primary regulator."[263] More specifically, Bartlett seeks to ascribe the market stability regulator with some overarching powers:

> The market stability regulator should not be just another layer of regulation added to the existing system; it should not be a "super-regulator". It should gather information with the assistance of other regulators, conduct joint examinations with other regulators, and, absent an emergency, take corrective actions with and through other financial regulators.
>
> (…)
>
> The purpose of a market stability regulator should be to promote the long-term stability and integrity of the nation's financial markets and financial services firms by identifying and addressing significant risks to the financial system as a whole. A market stability regulator should be authorized to oversee all types of all financial markets and all financial services firms, whether regulated or unregulated. However, a market stability regulator should not focus on financial services firms based upon size. The designation of "systemically significant financial services firms" would have unintended competitive consequences and increase moral hazard as these firms would be deemed "too big to fail."[264]

Furthermore, Bartlett suggested that a number of the smaller regulatory bodies merge to form a single unit, while the SEC and CFTC also merge to form a united regulator for capital markets and exchanges. Pre-empting accusations that the proposals simply amount to rearranging the status quo, Bartlett claimed that his strategy "places authority and accountability at specific regulatory agencies and further requires those agencies to adopt coherent and consistent standards."[265]

Former Treasury Secretary John Snow proposed a similar systemically-focused body:

> My suggestion here is that nobody sees the whole picture and we ought to put in place some institution of our government that has a clear view of and transparency on risk and leverage in the system. When you get right down to it, this is about excessive risk and excessive leverage.[266]

A new regulator with a systemic focus was also supported by Timothy Ryan, President and CEO of Securities Industry and Financial Markets Association. Although Ryan was more sanguine about the prospects of preventing future crises, he still argued that such a body could prove beneficial:

> Although the financial markets stability regulator may not be able to identify the causes or prevent the occurrence of every financial crisis in the future, by ensuring that a

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262 Ibid.

263 Steve Bartlett, Hearing on Regulation of Systemic Risk, House Committee on Financial Services, 17 March 2009

264 Ibid.

265 Ibid.

266 John Snow, US House Committee on Oversight and Government Reform, Hearing on the role of Federal Regulators and the Financial Crisis, 23 October 2008

> single regulator has clear responsibility, broad aggregated information (across various financial institutions), and the supervisory tools needed to minimize these risks when identified, we believe this will substantially improve the current system. At present, no single regulator (or collection of coordinated regulators) has the authority or the resources to collect information system-wide or to use that information to take corrective action in a timely manner across all financial institutions and markets regardless of charter.[267]

Ryan proposed that the systemic regulator should receive broad powers including the ability to act as lender of last resort, gather information from all market participants and adopt uniform financial regulations relating to systemic risk.

Bartlett further explained that this is a "global crisis and a mere domestic solution will not fix it."[268] Accordingly, any new regulatory system "should be coordinated with and consistent with international standards."[269] Timothy Ryan added that "we need a global approach to financial regulatory reform".[270]

Ranking Member of the HCFS, Spencer Bachus, adamantly stated his support for the introduction of a systemic regulator, although it must not have the power to dispense taxpayer-funded bailouts:

> In the event of a failure of these so called "too-big-to-fail" institutions, I believe that this newly created entity's role should be advancing an orderly resolution.
>
> If we have learned one lesson in the last year, it is this: when the government tries to manage and run these large corporations, no one wins. Government ownership and management of the private sector did not work in Russia, it did not work in China, it's not working in Cuba or North Korea, and it is clearly not working here.271

Identifying specific systemically-important institutions for protection and oversight received criticism from Peter Wallison of the American Enterprise Institute:

> But if we still believe that it is worthwhile to regulate systemically significant companies, and that regulation contrary to all our experience will actually prevent their failure, we should consider the adverse effects of doing so. One of the most severe of these adverse consequences is the effect on competition of designating certain institutions as systemically significant and thus placing them in a favorable competitive position with respect to their competitors. Even assuming that we can identify systemically significant institutions, what would be the consequences of regulating them? In my view, designating some companies as systemically significant would have a disastrous effect on the competitive financial system in the United States.
>
> (…)
>
> Even if the regulation of systemically significant companies did not have such adverse consequences for our economy and financial system, there is real doubt whether any agency would be able to regulate and supervise systemically significant firms from

[267] Timothy Ryan, Hearing on The Future of Financial Services Regulation, House Committee on Financial Services, 21 October 2008

[268] Ibid., Steve Bartlett

[269] Ibid.

[270] Ibid., Timothy Ryan

[271] Ibid., Ranking Member Spencer Bachus

> more than one industry. It goes without saying that banking is a completely different business from insurance, which is different from securities trading, which, in turn, is different from the risk-taking and arbitrage transactions of hedge funds.[272]

Wallison pointed to the actions of GSEs Fannie and Freddie as examples of the potential pitfalls associated with giving implicit government backing for systemically important firms. Furthermore, Wallison argued that the Fed – because it "would create significant conflicts with its monetary policy role and impair the independence that the agency needs to carry out that role effectively" – would not be well suited to the role of systemic regulator.[273]

The Fed has received strong criticism from Stiglitz, both in terms of its aims and its performance. Stiglitz argued that the Fed did not take a sufficiently broad perspective on financial regulation, focusing too narrowly on inflation:

> Part of the reason for the Fed's failure is that it has focused excessively on price stability-though to be sure, the mandate that we give the Fed (inflation, growth and employment) has resulted in a broader focus than in many other countries. The role of the Fed is not just to maintain price stability but to promote growth and high employment. It seemed to think that maintaining low inflation/stable prices was necessary and almost sufficient for economic stability and growth. But in fact, a single-minded focus on price stability may actually lead to greater economic instability, which requires a sound financial system. The Fed and central bankers around the world were focusing on second order inefficiencies associated with low inflation, as problems of financial market instability grew-with the resulting real loss of output and economic inefficiency that were so much larger.[274]

Stiglitz was also highly critical of the Fed's execution:

> The Fed has performed abysmally. Not only did it not do what it should have done to prevent the crisis, but it arguably contributed to the crisis. And it has not had an exactly steady hand in responding to the unfolding events.[275]

To counteract the Fed's narrow focus and the disparate set of regulators characterising the financial industry, Stiglitz supported the introduction of a new regulator – a "Financial Products Safety Commission" – which "would assess the risks of particular products and determine their suitability for particular users."[276] This body would also look at the pricing of financial products.

Max Baucus, Chairman of the Senate Finance Committee, also threatened the Fed's independence from Congress. He stated: "The role of the Fed has changed dramatically, so the usual defence of, well, we shouldn't intrude in the integrity and independence of the Fed, I think, no longer applies".[277]

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272 Ibid., Peter Wallison

273 Ibid.

274 Testimony of Joseph Stiglitz, Hearing on The Future of Financial Services Regulation, House Committee on Financial Services, 21 October 2008

275 Ibid.

276 Ibid.

277 Sacred territory, The Economist, 8 April 2009

Appendix – List of acronyms

AIG	American International Group
AIG-FP	American International Group – Financial Products division
bn	Billion
CDO	Collateralised debt obligation
CDS	Credit default swap
CEO	Chief executive officer
CFTC	Commodity Futures Trading Commission
CRA	Credit rating agency
Dow	Dow Jones Industrial Average Index
EESA	Emergency Economic Stabilization Act of 2008
Fannie or Fannie Mae	Federal National Mortgage Association
FDIC	Federal Deposit Insurance Corporation
Fed	Federal Reserve
Freddie or Freddie Mac	Federal Home Loan Mortgage Corporation
GSE	Government-sponsored enterprise
HCFS	House Committee on Financial Services
HCO	House Committee on Oversight and Government Reform
m	million
MBS	Mortgage-backed security
SCA	Senate Committee on Agriculture, Nutrition and Forestry
SCB	Senate Committee on Banking Housing and Urban Affairs
SEC	Securities and Exchange Commission
TARP	Troubled Asset Relief Program
tr	Trillion