Statement of
The Honorable John W. Snow
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United States House of Representatives
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Mr. Chairman, Ranking Member Davis, and Members of the Committee, we meet today under unprecedented circumstances.

Average Americans have been asking--quite properly--how this financial mess came about, how it will affect their financial future, and what remains to be done to get our economy going again. I very much appreciate the opportunity to share my perspective with you. I am not here to point fingers, but instead to share my thoughts on what we tried to accomplish during the years in which I served as Secretary of the Treasury, what went wrong in financial markets, and what we can do to avoid a comparable threat to our economic well-being in the future.

For the average American, a smooth-functioning banking system has helped make realization of the American dream possible. For decades, financial institutions provided the auto loans, student loans, and home mortgages that brought that dream closer. They provided the loans that small businesses used to meet their payrolls and to expand their operations. They provided a means of saving for retirement, or for a family vacation. In short, they helped us as a Nation to prosper.

Today, this system is badly shaken. For the sake of savers, small businesses, and homeowners, as well as American taxpayers more generally, problems in the system need to be corrected and confidence needs to be restored. In doing so, policy makers need to avoid saying or doing anything that could decrease confidence, increase market volatility, or undermine ongoing efforts by those in responsible positions to address the situation. In that spirit, I welcome the opportunity to offer some suggestions on what further steps might be undertaken to address the problems we as a Nation face. But before talking about what should be done, we need to assess what brought us to this stage.

What Went Wrong. The breakdown in our capital markets is the product of many complex and inter-related forces that were not fully apparent at the time and defy clear understanding even today. We continue to be surprised--even shocked--by unfolding events. In my view, we will spend years sorting out the many contributing factors and their relationship with each other, a partial view of which is now emerging.

Speaking broadly, what we have witnessed is a breathtaking breakdown in traditional risk management activities in the financial sector, from lax lending practices--including the now infamous "liar loans"--to the spread of highly complex and opaque financial products the risks of which weren't properly evaluated by issuers, investors, or rating agencies, all of which combined to create immense risks the scale of which wasn't readily apparent to anyone. All of this was occurring during a global savings glut that resulted in low interest rates. As a result, risk was under-priced on a global basis. The under-pricing of risk created the basic condition for the "search for yield" that led to new, exotic, opaque financial instruments, the inherent risks of which even issuers and investors failed to fully understand.

As has happened throughout history, low interest rates led to an increase in asset values, which fueled the housing boom. This environment of low interest rates underpinned the loose lending practices that led to the housing boom and the significant increase in consumption through equity extraction loans. This rise in consumption of course reduced household savings rates and exacerbated global asset imbalances, which were a major contributing factor in the boom which turned into a bubble that has now burst.

Throughout the housing finance value chain, many participants contributed to the creation of bad mortgages and the selling of bad securities, apparently feeling secure that they would not be held accountable for their actions. A lender could sell exotic mortgages to homeowners, apparently without fear of repercussions if those mortgages failed. Similarly, a trader could sell toxic securities to investors, apparently without fear of personal responsibility if those contracts failed. And so it was for brokers, realtors, individuals in rating agencies, and other market participants, each maximizing his or her own gain and passing problems on down the line until the system itself collapsed. Because of the lack of participant accountability, the originate-to-distribute model of mortgage finance, with its once great promise of managing risk, became itself a massive generator of risk.

In this environment, a critical lack of transparency in secondary markets left policy makers and regulators unable to discern the true nature and extent of the systemic risk that continued to build until it began to cascade unchecked here and then through the world economy. Unfortunately, our 20th century regulatory structure was ill-suited to addressing 21st century challenges.

This lack of transparency made it increasingly difficult for regulators to do their job. There were problems developing throughout the housing finance value chain, but regulators and market participants could not see them clearly. The financial instruments backed by Fannie Mae and Freddie Mac, for example, were marketed as low risk because of faith in rising housing markets and an implied government guarantee. But accounting irregularities hid the growing concentration of risk in them. Moreover, their use of hedging devices further masked this concentration. Finally, the law exacerbated these risks because it permitted a basic misalignment of incentives in the organizations, where losses could be socialized to taxpayers, but gains could be kept for shareholders. With this advantage, they operated like government-sponsored hedge funds, arbitraging low borrowing costs resulting from their implied government guarantee, driven to seek higher and higher profits for their private shareholders by expanding portfolio assets beyond those required to meet their public policy purpose. Their over-leverage, however, created systemic risks that became so large that government action would eventually become inevitable, in part because their instruments were held by so many large and small institutions around the globe.

The investment banking community also responded to the search for higher yields by manufacturing a variety of complex and opaque asset-backed financial vehicles, many linked to mortgage-backed securities. Many of these were given higher credit ratings than they deserved. While these instruments were being aggressively marketed as essentially risk-free, investment banks were simultaneously "shorting" them, hedging their bets against the very product they were selling with credit default swaps that further masked risk. Market participants kept adding to the growing risk, all assuming that the music would never end, or at least that they would be able to grab a chair before it did.

It was only when housing values began to fall in the second half of 2006, and when financial markets began to turn in August of 2007, that the true depth and breadth of the systemic risk to the market began to become apparent.

Our Efforts at Treasury. During my tenure as Secretary of the Treasury (February 3, 2003 to June 28, 2006), we began to see potential problems with over-leverage and attendant systemic risks. These potential problems--which were most visible in the context of Fannie Mae and Freddie Mac--intensified over time. In October 2003, I told Congress that we did not face a "current crisis, but we never want to get close to the point where we would face [a] problem" with the entire financial system. By April 2005, I told Congress that, "if something unravels," the size and concentration of GSE-related hedges "could cause systemic risk to the whole financial system." Other of my colleagues at the Treasury Department spoke out clearly about the more general breakdown in the market's under-valuation of credit risk. What eluded us, however, was a clear picture of the full extent of the risks to the financial system because of insufficient transparency.

Out of concern that the existing regulatory structure over all housing GSEs (Fannie Mae, Freddie Mac, and the Federal Home Loan Banks) was inadequate, I came before Congress for the first time in September 2003 to urge enactment of legislation to protect taxpayers and the integrity of the housing finance market. At the time, as I pointed out, there was "a general recognition that the supervisory system for housing-related government sponsored enterprises (GSEs) neither has the tools, nor the stature, to deal effectively with the current size, complexity, and importance of these enterprises." I thus urged Congress to enact legislation to create a new federal agency to regulate and supervise the financial activities of these entities and to enhance the government's conservatorship powers to handle a possible failure of the GSEs.

In April 2005, I testified again in support of much-needed GSE reform legislation, saying in part:

> Events that have transpired since I testified . . . in 2003 reinforce concerns over the systemic risks posed by the GSEs and further highlight the need for real GSE reform to ensure that our housing finance system remains a strong and vibrant source of funding for expanding homeownership opportunities in America. . . .
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> Allow me to state succinctly why the Administration is so committed to bring about real reform. The risks undertaken by the GSEs, if not properly managed, may pose a threat to their solvency, the stability of other financial institutions and the strength of the economy.

Throughout this period, we were met with stiff resistance by the housing industry and the mortgage industry. But we pressed on. Unfortunately, we were unable to persuade Congress to pass any version of the legislative options we put forward.

Members of Congress and the Administration justifiably wanted to continue to promote the American dream through home ownership. We thus strove to achieve the right balance between regulatory oversight and expanded opportunity. In retrospect, the bipartisan consensus to promote housing went too far. There was a push for too much of a good thing. Those excesses eventually came home to roost. Policy makers put too much emphasis on home ownership to the exclusion of other goals--thrift, savings, deficit reduction, and other productive investments. The United States as a whole saved too little, and spent too much. The housing bubble came to be a manifestation of those imbalances. Given the lack of transparency in the market, neither regulators nor market participants fully appreciated the systemic risks that were growing as a result of these imbalances.

In addition to the focus on the federal housing enterprises, I and other members of the President's Working Group on Financial Markets were active on a broad range of related policy issues. Within the Treasury Department, I established an economic surveillance and risk management process to monitor housing and other markets. We took additional steps as it became clear that the bank regulators, who were on the front lines of monitoring lending activity, had the best perspective on emerging housing markets conditions. In part due to laws stemming from the S&L crisis and others passed during the previous Administration, the Department was prohibited from participating in enforcement or regulatory actions of the bank regulators (including the Office of the Comptroller of the Currency and the Office of Thrift Supervision). It was rather unprecedented, then, when in 2005 I called in all of the housing and banking regulators to get a more comprehensive picture of what was going on in the housing markets. It was the only way to attempt to get such a picture.

At that time, the regulators were just starting to see spikes in the new no down-payment, adjustable rate, and negative amortization loans, and that activity was isolated in certain geographical areas. It was not seen as a national phenomenon. Default rates were low by historical standards, and the proportion of mortgages outstanding in those categories was still quite small. Given low unemployment and high GDP growth at the time, the potential for a decline in national housing prices was viewed as highly improbable. There was simply nothing in the historical record to support that kind of view. However, there was enough for us to know that better lending guidance would be useful. Following these meetings, the regulators proceeded with joint guidance on revised lending practices. In 2005, they published guidance on home equity lending, guidance that was revised in 2006 and expanded to include a focus on sub-prime lending.

It also had become clear that the regulatory system had contributed to the lack of transparency because of a bewildering array of federal and state authorities, with no one regulator having a full view. The regulatory process was proving out of date and in need of modernization. As a result, I commissioned work on a comprehensive blueprint for changing the system of financial regulation, including the creation of a systemic risk regulator, with the goal of issuing it to the next Congress. This study included the creation of a federal charter for insurance, something I publicly endorsed at the time. That effort ultimately led to the blueprint put forward by the Department earlier this year, which is now beginning to get the attention it deserves.

We also began an initiative with our colleagues in the United Kingdom and the European Union to make sure we were prepared to manage and respond to financial crises should one arise for any reason.

Where Do We Go From Here? Whatever the cause of a banking crisis, a lesson from history is that early, decisive government action is needed to stem the pain and cost of it. We must recognize as well that booms and busts in our financial markets, while unwelcome, have been a recurring part of our economic history. They seem to be an inevitable--though clearly undesirable--aspect of financial markets. Our history, however, also tells us that financial markets recover.

An important part of the recovery is correcting the excesses that led to the boom. With the recent enactment of sweeping rescue legislation at the beginning of October, Congress has given our regulatory authorities an extraordinary range of tools. In addition, we are seeing banks, credit card companies, and other financial institutions significantly tighten lending standards. The guidance of credit rating agencies is certainly being scrutinized more carefully today and banks are going back to asking the question "Can the borrower repay this loan?" rather than relying on a FICO score or the value of the underlying collateral. In addition, purchasers of financial instruments are certainly doing a lot more due diligence. LBO activity has dwindled and risk premiums have increased. In fact, the current credit crunch reflects something of an over reaction that hopefully good governmental policy to increase liquidity and banking capital along with the loan guarantees will help alleviate.

In addition to the efforts by regulators here, international coordination of efforts is finally underway. I want to commend Prime Minister Gordon Brown and Governor Mervyn King for the leadership they have shown in this regard. Their move to guarantee interbank lending offers a positive model for unfreezing markets that have been slow to unlock.

Longer term, we need to fix the U.S. financial system and recast the international financial architecture as well. Let me suggest a number of steps.

First, I propose that financial policy be re-organized around a clear principle: increasing transparency of excessive leverage as a means of preventing institutions from creating excessive systemic risk. This would mean reorienting our entire regulatory scheme to focus on leverage. We now know that looking solely at capital standards has proven to be inadequate. We need a new framework to stem the excessive leveraging and deleveraging that accentuate boom and bust cycles. This doesn't mean that securitizing assets is fundamentally flawed. Far from it. But we do need mechanisms to ensure transparency and accountability. We need to restore a focus on good risk management practices. Those who make loans need to ask how they will be repaid, and get reliable information to support loan decisions. When loans are packaged for the secondary market, originators should be required to hold on to a portion of the underlying loans. One would expect the market to reward this extra sign of due diligence.

As a related matter, we need to move beyond "too big to fail." We have to restore market discipline by taking steps to minimize the instances where financial institutions could ever be deemed too big to fail, while making sure that the institutions themselves--rather than taxpayers--bear the costs of failure. We should create a permanent mechanism for the dissolution of financial institutions, not just depository institutions.

Second, we need a more coordinated and less fragmented approach to financial regulation. We need one strong national regulator with the field of vision to spot excessive leverage, no matter what or where the institution is located. We need to move away from the alphabet soup of regulatory responsibility that has prevented a comprehensive approach. This change too would facilitate treating financial institutions engaged in like activities in a similar manner, and avoid regulatory arbitrage. In addition, we need stronger oversight of rating agencies and elimination of conflicts of interest that have clouded their work.

As a corollary matter, we need to forge greater international cooperation to deal with spillover effects from under-pricing of risk and excessive leverage. We need a level playing field for market participants. More rapid convergence of national standards and greater cooperation of national regulators are needed.

Third, we need to make sure our markets stay open and that we encourage expanded trade in goods and services. Capital flows from sovereign wealth funds, for example, have played an important role in stabilizing our financial system. They should continue to be welcomed. Moreover, a renewed push to restart and conclude the global trade round would give a much needed lift to the U.S. economy and financial markets, as our export sector has provided such an important source of support during this downturn.

Finally, we need to avoid an overreaction that could stunt prudent risk taking and innovation, which could reduce living standards for a decade or more. Congress has given the Treasury Department and the Federal Reserve Board an impressive array of tools to work with to restore the market. Let's give these policy makers and regulators a chance to use these tools, and let's encourage the next Administration and the Congress to consider how best to build a regulatory structure for the 21st century.

In conclusion, the American people are looking now for constructive steps to protect their economic future, and to put the economy back on the path to growth and job creation. While the cyclical nature of the economy will never be outlawed, steps to restore transparency and responsibility in the marketplace will go a long way towards restoring stability and confidence. With their leaders working cooperatively to put good policies in place, I remain confident that the American public's inherent resilience and strength will carry the day.

Thank you again for the opportunity to appear today.