U.S. House of Representatives
Committee on Financial Services
Statement of
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The current state of the U.S. financial regulatory system is the result of an extreme breakdown in confidence by the credit markets in this country and elsewhere so that U.S. regulatory authorities have determined it necessary to practically underwrite the entire process of credit provision to private borrowers. All significant U.S. financial institutions that provide credit have some form of access to a Federal Reserve liquidity facility at this time. All institutional borrowers through the commercial paper market are now supported by the Federal Reserve System. Many of the major institutional players in the U.S. financial system have recently been partially or fully nationalized. While it appears that the Federal Reserve along with other central banks has successfully addressed the fear factor regarding access to liquidity, there are lingering fears in the markets about the economic viability of many financial firms due to the poor asset quality of their balance sheets.

All of these measures to restore confidence are the result of huge structural and behavioral flaws in the U.S. financial system that led to excessive expansion in subprime mortgage lending and other credit related derivative products. Because these structural problems have encouraged distorted behavior over a long period of time, it will take some time to completely restore confidence in the credit markets. However, over time as failed financial institutions are resolved through private market mergers or asset acquisitions in government takeovers and restructurings, confidence in the U.S. credit system should be gradually restored. Unfortunately, this process will likely be very costly to U.S. taxpayers.

Over the longer term, the public should be very concerned about the implications of the legislative and regulatory efforts to deal with this crisis of confidence. From my perspective, permanent government control over the credit allocation process is economically inefficient and potentially even more unstable. One of the major reasons why excesses developed in housing finance was a failure of federal regulators to adequately supervise the behavior of bank holding companies. Specifically, the emergence of special investment vehicles (SIVs), an off-balance-sheet innovation by bank holding companies to avoid the capital requirements administered by the Federal Reserve, set in motion a virtual explosion of toxic mortgage financings. While the overall structure of bank capital reserve requirements was sound relative to bank balance sheets, supervisors were oblivious to bank exposures off the balance sheet. If bank supervisors could not police the previous and much less pervasive regulatory structure, you can imagine the impossibility of policing a vastly more extensive and complicated structure. Again, while bank capital requirements are reasonably well designed, it is supervision that is a problem.

The U.S. financial system has been the envy of the world. Its ability to innovate and disburse capital to create wealth in the U.S. and around the globe is unprecedented. A new book by my colleague David Smick, titled *The World Is Curved*, documents the astonishing benefits the U.S. financial system has provided in the process of globalization. The book also clearly describes the dangers presented by regulatory and structural weaknesses.

It would be a mistake to roll back the clock on the gains made in U.S. finance over the last several decades. As the current crisis in confidence subsides and stability is restored, U.S. regulators should develop clear transition plans to exit from direct investments in private financial institutions and attempt to roll back extended guarantees to credit markets beyond the U.S. banking system. Successfully supervising the entire U.S. credit allocation process is simply impossible without dramatically contracting the system. More resources and effort should be put into supervision of bank holding companies. Financial regulators should focus on full transparency in securitization development and clearing systems. Accurate disclosure of risks is the key to effective and sound private sector credit allocation. Reforms following these principles should help maintain U.S. prominence in global finance and enhance living standards both domestically and internationally.