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Mr. Chairman and members of the committee:

I am pleased to have this opportunity to address the question of regulation and its role in the current financial crisis.

There are cases where regulation is necessary, and cases where it is harmful.

It was necessary in the case of Fannie Mae and Freddie Mac. These two companies were seen in the markets 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.

In cases where investors see themselves as bearing no risks for lending to a private, shareholder-owned company, strong regulation is essential. That is the only way that the government can protect itself against loss.

Yet Congress resisted reforming the regulation of 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.

This failure by Congress had serious consequences. An article in yesterday's *New York Times* makes clear that reckless buying of junk loans by Fannie Mae bears a large part of the responsibility for the financial crisis we are now in. Voters, justifiably angry about the $700 billion rescue plan just adopted by Congress, should recognize who is responsible and act accordingly.

Bad or weak regulation is often worse than no regulation at all. Another article in the *New York Times*—on Friday of last week—recounted the SEC's failure to devote sufficient resources to the regulation of the major investment banking firms that have now all collapsed, been taken over, sold themselves to big banks, or sought shelter under the Federal Reserve's wings as financial holding companies.

According to the article, the SEC assigned a pitifully small staff to regulating these huge investment banks, and as a result they took the imprudent financial risks that ultimately led to their losses.

A chart accompanying the article shows that these institutions took increasing risks every year from the time they entered the SEC supervisory regime. This is important. It demonstrates the effect of regulation in creating moral hazard. Immediately after the SEC took over the supervision of their safety and soundness, the market discipline to which they had previously been subject began to relax. Investors thought the SEC was minding the store. But it wasn't.

That's why weak regulation can be worse than none.

Regulation itself is no panacea. Even strong regulation may not be effective. The regulation of commercial banks in the United States is a case of strong regulation failing. Congress imposed a strong regulatory regime on commercial banks when it adopted FDICIA in 1991.

Still, even though IndyMac, WAMU, Wachovia and dozens of smaller commercial banks were regulated by one or another agency of the federal government under strict FDICIA requirements, they all failed just like the weakly regulated investment banks.

Calling for more regulation as a solution to the financial crisis is simplistic. Regulation's track record is ambiguous.

There is no question that it's the only protection we have when the government is exposed to the risks created by companies it backs—like commercial banks, which have deposits insured by the FDIC; and like Fannie Mae and Freddie Mac, which were seen as backed by the federal government without any limit.

But the regulation of the investment banks by the SEC was a mistake. They were not seen as backed by the government in any way, until the SEC was given authority to supervise their safety and soundness. Then their risk-taking took off.

If they had been left free of government oversight, they would not—in my view--have been able to borrow the funds that created their extraordinary leverage.

If our solution to today's crisis is to regulate hedge funds, private equity funds, finance companies, institutional lenders, pension funds, leasing companies, and insurance companies—and anyone else who participates in the capital markets without any government backing—we will simply be assuring ourselves of many more financial crises in the future.

Many thanks for your attention.