Statement by Senator Carl Levin (D-Mich)

Before

Homeland Security and Governmental Affairs Committee

On

Where Were the Watchdogs?
The Financial Crisis and the Breakdown of Financial Governance

January 21, 2009

Today's hearing provides an opportunity to deepen our analysis of what has gone wrong with the U.S. financial system, and what reforms are needed not only to end the immediate crisis, but to rebuild our financial architecture and strengthen investor, consumer, and taxpayer protections.

This exercise is not a new one. History has proven time and again that markets are not self-policing. The Pecora hearings before a Senate Committee in the 1930s pulled back the curtain on the abuses that gave rise to the Great Depression. Hearings since then have documented a litany of abuses by financial firms trying to take advantage of investors and markets for private gain.

In recent years, for example, Congressional hearings -- including by the Permanent Subcommittee on Investigations which I chair -- showed how Enron cooked its books, deliberately distorted energy prices, and cheated on its taxes, becoming the seventh largest corporation in the country before its collapse. Our Subcommittee hearings also showed how leading U.S. financial institutions such as Citigroup, JPMorgan Chase, and Merrill Lynch willingly participated in deceptive transactions to help Enron inflate its earnings. Some of our other hearings have disclosed U.S. corporations engaged in misleading accounting, offshore tax abuses, excessive stock option payments, and other disturbing practices. Our 2007 hearing showed how a single hedge fund named Amaranth made massive commodity purchases on both regulated and unregulated energy markets to profit from distorted energy prices they helped generate, causing U.S. consumers to pay more. Our hearing last year showed how Lehman Brothers, Morgan Stanley, and others helped offshore hedge funds dodge payment of U.S. taxes on U.S. stock dividends by facilitating complex swap agreements and stock loan transactions. Other Congressional hearings have shown how Countrywide and others sold abusive mortgages, overcharged borrowers, and offloaded defective mortgage-based securities onto the market.

Part of the explanation for these recent abuses is a history of actions that have gradually weakened our financial regulatory system. This chart lists just a few of those actions over the last ten years, which have included blocking regulation of over-the-counter derivatives; repealing the Glass-Steagall wall separating banks, broker-dealers, and insurers; authorizing unregulated electronic commodity markets for large energy traders; weakening the capital requirements for broker-dealers; and more.

It hasn't been all one way. After the Enron scandal, we were able to enact the Sarbanes-Oxley Act that strengthened oversight of the accounting profession, required stronger financial controls, and made other improvements. Last year, we successfully closed the Enron loophole barring government oversight of electronic energy markets for large traders. But stronger market regulation has been the exception, not the rule, and had to be won despite naysayers claiming markets work best with minimal regulation. But the current crisis shows that minimal regulation is a recipe for disaster, an overhaul of Wall Street regulation is long overdue, and Congress needs to act now to fix a broken system.

As Congress and the new Administration begin the work of financial restructuring and our Committee begins to examine the issues, I would like to offer some observations about needed financial reforms. The first is that Congress needs to put a cop on the beat in every financial market with authority to police every type of market participant and financial instrument to stop abuses. We need to eliminate the statutory barriers, for example, that prohibit federal regulation of credit default swaps, hedge funds, and derivative traders. We also need to enact new limits on high risk activities including preventing banks from running their own hedge funds and requiring increased oversight of offshore activities. Congress also needs to reduce the concentration of risk to the taxpayer by preventing any one bank from holding more than 10% of U.S. financial deposits, and to institute new protections to stop financial institutions from profiting from practices that abuse investors and consumers.

Let me explain.

Bigger is Not Better. To move forward it is important first to look back. Until relatively recently, U.S. law prohibited federally-chartered banks from branching across state lines. Instead, U.S. banking consisted primarily of thousands of modest-sized banks tied to local communities. In contrast to other countries which typically have had a few dozen banks or less, the United States is home to more than 15,000 banks, thrifts, and credit unions. The United States is almost alone in the world in its large number of banks, and the benefits are clear. When one bank suffers losses, the government can shut it down, protect depositors, and avoid damage to the banking system and economy. Decentralized banking also promotes competition, spreads credit through the marketplace, and prevents undue concentrations of financial power.

In the mid 1990s, however, we began to move away from the U.S. tradition of modest-sized banks. In 1994, for the first time, Congress authorized interstate banking, which allowed federally chartered banks to open branches nationwide. In 1999, Congress repealed the Glass-Steagall wall separating banks, securities firms, and insurance companies, and allowed them to merge. Most of us agreed to allow this wall to come down only on the understanding that strong SEC regulation of bank's trading activities would follow. But that didn't happen.

In 2000, deregulation went further. The Enron loophole allowed U.S. financial institutions to start trading derivatives on unregulated electronic energy markets for large traders. In 2004, the SEC relaxed capital requirements for large securities firms, allowing them to grow even larger using borrowed funds. Affiliated derivative traders, hedge funds, and private equity shops began operating outside the federal regulatory framework, becoming ever more powerful market participants. New financial instruments such as credit default swaps also gained favor, again outside regulatory constraints.

Each of these steps helped pave the way for a relatively small number of U.S. firms to become giant financial conglomerates involved in collecting deposits, financing loans, trading commodities, and buying, selling, issuing, underwriting, and insuring billions of dollars in stock, debt instruments, insurance policies and derivatives. When one of these financial mammoths got into trouble, it could not be easily closed. Now that many are in trouble, their problems have severely damaged U.S. credit markets, destabilized the stock market, and even threatened the viability of the U.S. financial system.

The Bush Administration's response to this crisis has been to allow some of the biggest institutions to expand even more. With the blessing of regulators, Bank of America swallowed up Merrill Lynch. JPMorgan Chase took over Washington Mutual. Wells Fargo purchased Wachovia. Treasury committed $125 billion in new capital to the nine largest U.S. financial institutions, and has encouraged them to use the funds, not just to unlock credit markets or repair troubled assets, but to buy up still more financial institutions.

As lawmakers begin to revamp our system of financial regulation, one guiding principle should be to remember the roots of American financial strength, which includes reliance on a network of financial institutions, without behemoths that are too big to be allowed to fail and require massive taxpayer bailouts when problems arise. While it may be too late to restore the banking landscape of 15 years ago, it is not too late to curb further abuse. One of the key constraints is a statutory prohibition on approving mergers of financial institutions with more than 10 percent of U.S. bank deposits. That law should be expanded to prohibit any institution from exceeding the 10 percent limit and to include deposits of all types. Another suggestion is to prohibit banks from owning hedge fund or private equity affiliates, and to limit the trading they do on their own behalf.

Put a Cop on Every Beat. Despite the evidence that markets are not self-policing, some policymakers have invoked the mantras of free markets, financial innovation, and financial self-interest to argue for minimal market regulation. During the past decade, these arguments largely succeeded. The result today is a wide array of gaps in U.S. financial regulation exempting various types of financial instruments, financial institutions, and even whole markets from government oversight. Those gaps need to be closed.

The 2000 Commodity Futures Modernization Act, for example, currently bars federal regulation of over-the-counter derivatives markets, and prohibits SEC and CFTC regulation of all types of swap agreements, including credit default swaps that have now evolved into a $50 trillion market. Holding companies of major U.S. securities firms are able to operate outside of SEC regulation. So can some derivatives traders. Hedge funds, carefully designed to evade SEC rules, have become unregulated heavyweights in U.S. markets and are the last major U.S. financial players without any anti-money laundering obligations.

Another regulatory gap involves the so-called "revolving door" between the regulating agencies and the financial institutions they're charged with overseeing. Too often, oversight suffers because regulators are positioning themselves for lucrative jobs in the private sector. An investigation by the Subcommittee found that a senior bank examiner charged with overseeing Riggs Bank when the bank was conducting questionable transactions for former Chilean President Augusto Pinochet and the government of Equatorial Guinea, retired from his agency and went to work for Riggs Bank three days later. Following this investigation, Congress passed a law imposing a one-year cooling off period before a senior federal bank examiner can take a job with a financial institution that he or she was responsible for overseeing. Similar cooling-off periods should be instituted for other financial regulators.

Perhaps the most glaring regulatory gap of all involves offshore jurisdictions. About 50 offshore jurisdictions operate globally, attracting clients by trumpeting secrecy laws, minimal or no taxation, and little or no financial regulation. Some are on international blacklists for failing to cooperate with international law enforcement efforts to stop tax evasion or money laundering. Offshore abuses alone cost the U.S. Treasury an estimated $100 billion in unpaid taxes each year. Yet the United States allows offshore hedge funds, corporations, trusts, and other entities to open accounts at our banks, invest in our markets, provide financial services to U.S. clients, and participate in transactions designed to dodge U.S. taxes. Moreover, we allow U.S. financial institutions to open offshore branches immune to U.S. capital requirements, engage in offshore transactions hidden from investors, and incur risk from undisclosed offshore obligations and holdings.

It is time to close these and other glaring gaps in U.S. financial regulation. Lawmakers need to eliminate the statutory barriers that prohibit federal regulation of financial activities, enact rules to protect investors and market integrity, and put a cop on every beat with clear authority to enforce those rules and stop abuses. At a minimum, federal regulation and the cop on the beat need to be authorized to police unregulated commodity trades, swap agreements and other derivatives, hedge funds, investment bank holding companies, derivative traders, and offshore entities.

Limit High Risk Activity. Another critical deficiency in the existing U.S. regulatory system is its failure to impose effective limits on high risk financial activity by regulated financial institutions. Over the past 10 years, regulatory controls over high risk investments were relaxed and oversight by regulators was largely absent.

For example, for 30 years, from 1975 to 2004, the SEC required securities firms to comply with a net capital rule containing bright-line requirements for calculating capital reserves. The rule worked well. But in 2004, the SEC added an “alternative” to the rule and allowed the largest securities firms to use a less strict “risk-based” approach. In response, the largest securities firms used the alternative to lower their capital reserves, increase borrowing, and buy more risky investments. When trouble hit, they generally had insufficient capital to weather the storm.

On the bank side, capital requirements were stronger, but it is clear that they remain insufficient. After the repeal of Glass-Steagall, many banks increased the volume of their securities transactions, not only for their clients but on their own behalf. Many banks also engaged in higher risk investments, buying subprime mortgages and collateralized debt obligations, entering into credit default swaps, and trading over-the-counter derivatives. Regulators allowed “well capitalized” banks to take on more risk, even when missteps by large banks could necessitate a taxpayer bailout. The result has been a capital and liquidity crisis.

In addition to inadequate capital and liquidity requirements, federal regulators failed to stop individual financial institutions from incurring excessive risk. In 2002, after the Enron debacle, my Subcommittee convinced federal bank and securities regulators to conduct a joint review of complex structured financial transactions at the dozen largest banks and securities firms and in, 2004, propose new guidance to limit problems. Three years later, in 2007, however, the regulators issued final guidance that was much weaker. The regulators eliminated, for example, provisions warning against the use of abusive transactions; provisions specifying the steps that corporate boards, senior management and legal counsel should take to prevent abuses; provisions detailing good recordkeeping practices; and provisions recommending establishment of a board policy on acceptable risk levels from complex structured transactions. In effect, the 2007 guidance issued by the bank regulators and the SEC dismantled many of the risk protections proposed in 2004. The SEC also set up, but then underfunded, an office intended to detect and prevent systemic risk in the financial system. At the same time, bank regulators, despite having authority to ensure a bank's sound operation and screen new bank products and investments, failed to limit bank participation in high-risk activity.

The agencies' failure to use the regulatory authority they had was due in part to the Bush Administration's philosophical opposition to market controls and uncritical support of "financial innovation." Banks were allowed to trade exotic financial instruments and set up their own hedge funds and private equity affiliates. In addition, government oversight was hindered by the 2000 statutory prohibition already mentioned barring federal regulation of swap agreements and the over-the-counter derivative markets. This prohibition meant, for example, that the SEC could not require public companies to calculate, disclose, or limit their swap holdings.

One consequence was the surprise announcement that AIG, one of the largest companies in America, had issued credit default swaps insuring the repayment of debt totaling an estimated $440 billion. As the holding company for a thrift, AIG is regulated by the Office of Thrift Supervision as well as the SEC, but neither agency ever placed a limit on its credit default swaps, because the law barred them from doing so. Even Alan Greenspan now admits that doesn't make sense. The fear that other companies also have undisclosed credit default obligations is partially responsible for lenders' reluctance to lend funds to each other, and to businesses and consumers.

In addition to these regulatory failures to control risk, another key contributor to the current crisis is the credit rating agencies that repeatedly issued safe credit ratings for high-risk investments. Recent Congressional hearings disclosed the internal misgivings at the top three credit rating agencies, Moody's, Standard & Poor's, and Fitch, about their own ratings. Internal emails contained the following: "Combined, these errors make us look either incompetent at credit analysis, or like we sold our soul to the devil for revenue, or a little bit of both." "[Our rating] model def[initely] does not capture half of the … risk. … We should not be rating it." "[Credit rating agency professionals are] continually 'pitched' by bankers, issuers, investors … whose views can color credit judgment." "Let's hope we are all wealthy and retired by the time this house of cards falters." Over the past year, triple-A bonds have been re-categorized as junk bonds, and bank investments have plummeted in value. The credibility of the credit rating agencies has plummeted as well, with a paralyzing effect on markets.

To stop high risk investments from damaging the U.S. financial system, lawmakers could strengthen capital and liquidity requirements for banks, restore the net capital rule for securities firms, and require procedures to oversee and limit high risk investments, including credit default swaps, over-the-counter derivatives, and offshore transactions. Asset backed securities could be rejuvenated by including new investor protections, such as those used in credit card securitizations which require the issuer to continue to hold a financial stake in the securities offered to the public. As mentioned earlier, banks could also be prohibited from operating their own hedge fund or private equity affiliates that, by design, target high-risk investments.

Another sensible reform would be to impose strong due diligence obligations on all persons involved in issuing bonds and other securities for sale, including underwriters, distributors, and rating agencies. Action should also be taken to end the conflicts of interest that distort credit ratings, either by requiring credit rating agencies to be paid by investors or, if that wouldn't support a rating system, by setting up a new process in which those seeking ratings pay fees to a government-sponsored oversight board, similar, perhaps, to the existing accounting oversight board, to register, police, and compensate credit rating agencies. To stop offshore abuses, the Levin-Coleman-Obama Stop Tax Haven Abuse Act offers multiple provisions to end the use of offshore tax havens to dodge taxes or hide financial activity from regulators and the public.

Main Street Over Wall Street. A final principle to guide the restructuring effort is to strengthen investor, consumer, and taxpayer protections to stop financial institutions from profiting from practices that abuse investors or consumers. To date, hundreds of billions of taxpayer dollars have gone to recapitalize Wall Street, purchase troubled assets, and insure financial instruments. Little has been spent to protect Americans on Main Street from unfair financial practices.

Investor protections, at a minimum, should include reliable accounting rules, executive pay limits, and stronger anti-fraud protections by reversing the Stoneridge case. Some in the corporate world don't like tough accounting rules, because those rules disclose financial problems. But that is exactly what investors have a right to know. Some corporate leaders oppose executive pay limits, because they want to continue to pull down outsized compensation from company coffers in good times and bad. But shareholders should be able to limit excessive executive pay at the companies they own, and taxpayers shouldn't have to subsidize million-dollar pay.

In Stoneridge, the Supreme Court determined that shareholders are barred by federal law from suing third parties that help public companies commit fraud, and must instead rely on federal regulators to punish wrongdoing and recover funds. Given limited federal resources, however, that ruling means, in too many cases, banks, accounting firms, lawyers and others will be able to aid and abet corporate fraud, and shareholders will have no legal recourse. That isn't fair, and it undermines investor confidence in U.S. markets.

Homeowners also lack protection against unfair financial practices. The subprime crisis is the product, in part, of predatory lending practices directed at less sophisticated borrowers. Those practices included subprime mortgages sold to borrowers who qualified for better loans, use of dishonest appraisals, and the sale of mortgages containing exploding interest rates, unfair prepayment penalties, and excessive fees. Selling loans with inherently unfair elements should not be allowed. In addition, mechanisms need to be developed to make it easier to reform unfair mortgages after they are issued. It is also important to create incentives for financial institutions to issue loans that can be paid back, rather than nonviable loans issued primarily to collect fees.

Consumers also need protection from abusive practices by credit card issuers, including the five large banks that control 80% of the credit card market, Bank of America, Capital One, Citigroup, Discover, and JPMorgan Chase. Unfair credit card practices include interest rates as high as 30%, excessive fees, interest rate hikes on consumers with years of on-time payments, higher interest rates applied retroactively, charging interest for debt paid on time, bills sent out with insufficient time to make a payment, and applying consumer payments in ways that maximize debt. These abusive lending practices mire too many American families in debt.

Solutions to these problems are at hand. Legislation already exists that would put an end to predatory lending and credit card abuses; give shareholders a say on executive pay and a voice on corporate boards; and place new limits on corporate stock option and executive pay. Legislation reversing Stoneridge would restore civil liability for aiders and abettors of corporate fraud. Honest accounting can be preserved primarily by rejecting attempts to weaken U.S. rules, including calls to abandon mark-to-market valuation, to replace U.S. auditing and accounting standards with weaker international standards, or to eliminate Sarbanes-Oxley requirements for strong internal controls at companies. Lawmakers should also consider establishing a financial safety commission to evaluate new financial products aimed at consumers and prevent abusive products from going on the market.

Conclusion. The current financial crisis has exposed fundamental flaws in U.S. financial regulation and demonstrates why it is an absolute necessity to correct them. One set of issues to be confronted involves deciding which regulatory agency should exercise what type of oversight. But as important as that set of issues is a more basic one – whether all types of market participants, financial instruments, and markets should be subject to regulation and oversight. In my view, Congress and the new Administration should use this opportunity to close all the regulatory gaps that now weaken our laws; put a cop on every financial beat; and strengthen investor, consumer, and taxpayer protections, including by limiting the size of individual banks. I look forward to the testimony today to learn more about how to move America forward.

A DECADE OF WEAKENING FINANCIAL REGULATION

Oct. 1998	At the request of the SEC, Treasury, and Federal Reserve, Congress blocks funding for any CFTC regulation of over-the-counter derivatives.
Nov. 1999	Gramm-Leach-Bliley Act repeals 1933 Glass-Steagall wall separating banks, broker-dealers, and insurers.
Dec. 2000	Commodity Futures Modernization Act prohibits swaps regulation and opens Enron loophole allowing unregulated energy markets for large traders.
Aug. 2003	SEC delays requiring auditors of private broker-dealers to register with Public Company Accounting Oversight Board.
Oct. 2003	SEC proposes but never adopts rule on shareholder nominations of directors.
June 2004	SEC weakens net capital rule for securities firms.
June 2006	Court of Appeals invalidates SEC regulation requiring hedge fund registration.
Jan. 2007	SEC and bank regulators weaken guidance for oversight of complex structured finance products.
July 2007	SEC eliminates 1938 uptick rule that had put certain limits on short stock sales.
Dec. 2007	SEC allows foreign companies trading on U.S. exchanges to use international financial reporting standards without a reconciliation to U.S. generally accepted accounting principles.
Jan. 2008	Supreme Court issues <u>Stoneridge</u> decision barring shareholder suits against third parties that help public companies commit fraud.

Prepared by Senator Levin
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