Testimony of Robert Kuttner

Before the Committee on Financial Services

U.S. House of Representatives

Washington, D.C.

October 2, 2007

Mr. Chairman and members of the Committee:

Thank you for this opportunity. My name is Robert Kuttner. I am an economics and financial journalist, author of several books about the economy, a magazine editor, and former investigator for the Senate Banking Committee. I have a book appearing in a few weeks that addresses the systemic risks of financial innovation coupled with deregulation and the moral hazard of periodic bailouts.

In researching the book, I devoted a lot of effort to reviewing the abuses of the 1920s, the effort in the 1930s to create a financial system that would prevent repetition of those abuses, and the steady dismantling of the safeguards over the last three decades in the name of free markets and financial innovation.

The Senate Banking Committee, in the celebrated Pecora Hearings of 1933 and 1934, laid the groundwork for the modern edifice of financial regulation. I suspect that they would be appalled at the parallels between the systemic risks of the 1920s and many of the modern practices that have been permitted to seep back in to our financial markets.

Although the particulars are different, my reading of financial history suggests that the abuses and risks are all too similar and enduring. When you strip them down to their essence, they are variations on a few hardy perennials – excessive leveraging, misrepresentation, insider conflicts of interest, non-transparency, and the triumph of engineered euphoria over evidence.

The most basic and alarming parallel is the creation of asset bubbles, in which the purveyors of securities use very high leverage; the securities are sold to the public or to specialized funds with underlying collateral of uncertain value; and financial middlemen extract exorbitant returns at the expense of the real economy. This was the essence of the abuse of public utilities stock pyramids in the 1920s, where multi-layered holding companies allowed securities to be watered down, to the point where the real collateral was worth just a few cents on the dollar, and returns were diverted from operating companies and ratepayers. This only became exposed when the bubble burst. As Warren Buffett famously put it, you never know who is swimming naked until the tide goes out.

There is good evidence--and I will add to the record a paper on this subject by the Federal Reserve staff economists Dean Maki and Michael Palumbo--that even much of the boom of the late 1990s was built substantially on asset bubbles. ["Disentangling the Wealth Effect: a Cohort Analysis of Household Savings in the 1990s," http://www.federalreserve.gov/pubs/feds/2001/200121/200121pap.pdf]

A second parallel is what today we would call securitization of credit. Some people think this is a recent innovation, but in fact it was the core technique that made possible the dangerous practices of the 1920. Banks would originate and repackage highly speculative loans, market them as securities through their retail networks, using the prestigious brand name of the bank – e.g. Morgan or Chase -- as a proxy for the soundness of the security. It was this practice, and the ensuing collapse when so much of the paper went bad, that led Congress to enact the Glass-Steagall Act, requiring bankers to decide either to be commercial banks—part of the monetary system, closely supervised and subject to reserve requirements, given deposit insurance, and access to the Fed's discount window; or investment banks that were not government guaranteed, but that were soon subjected to an extensive disclosure regime under the SEC.

Since repeal of Glass Steagall in 1999, after more than a decade of de facto inroads, super-banks have been able to re-enact the same kinds of structural conflicts of interest that were endemic in the 1920s – lending to speculators, packaging and securitizing credits and then selling them off, wholesale or retail, and extracting fees at every step along the way. And, much of this paper is even more opaque to bank examiners than its counterparts were in the 1920s. Much of it isn't paper at all, and the whole process is supercharged by computers and automated formulas. An independent source of instability is that while these credit derivatives are said to increase liquidity and serve as shock absorbers, in fact their bets are often in the same direction – assuming perpetually rising asset prices – so in a credit crisis they can act as net de-stabilizers.

A third parallel is the excessive use of leverage. In the 1920s, not only were there pervasive stock-watering schemes, but there was no limit on margin. If you thought the market was just going up forever, you could borrow most of the cost of your investment, via loans conveniently provided by your stockbroker. It worked well on the upside. When it didn't work so well on the downside, Congress subsequently imposed margin limits. But anybody who knows anything about derivatives or hedge funds knows that margin limits are for little people. High rollers, with credit derivatives, can use leverage at ratios of ten to one, or a hundred to one, limited only by their self confidence and taste for risk. Private equity, which might be better named private debt, gets its astronomically high rate of return on equity capital, through the use of borrowed money. The equity is fairly small. As in the 1920s, the game continues only as long as asset prices continue to inflate; and all the leverage contributes to the asset inflation, conveniently creating higher priced collateral against which to borrow even more money.

The fourth parallel is the corruption of the gatekeepers. In the 1920s, the corrupted insiders were brokers running stock pools and bankers as purveyors of watered stock. 1990s, it was accountants, auditors and stock analysts, who were supposedly agents of investors, but who turned out to be confederates of corporate executives. You can give this an antiseptic academic term and call it a failure of agency, but a better phrase is conflicts of interest. In this decade, it remains to be seen whether the bond rating agencies were corrupted by conflicts of interest, or merely incompetent. The core structural conflict is that the rating agencies are paid by the firms that issue the bonds. Who gets the business – the rating agencies with tough standards or generous ones? Are ratings for sale? And what, really, is the technical basis for their ratings? All of this is opaque, and unregulated, and only now being investigated by Congress and the SEC.

Yet another parallel is the failure of regulation to keep up with financial innovation that is either far too risky to justify the benefit to the real economy, or just plain corrupt, or both. In the 1920s, many of these securities were utterly opaque. Ferdinand Pecora, in his 1939 memoirs describing the pyramid schemes of public utility holding companies, the most notorious of which was controlled by the Insull family, opined that the pyramid structure was not even fully understood by Mr. Insull. The same could be said of many of today's derivatives on which technical traders make their fortunes.

By contrast, in the traditional banking system a bank examiner could look at a bank's loan portfolio, see that loans were backed by collateral and verify that they were performing. If they were not, the bank was made to increase its reserves. Today's examiner is not able to value a lot of the paper held by banks, and must rely on the banks' own models, which clearly failed to predict what happened in the case of sub-prime. The largest banking conglomerates are subjected to consolidated regulation, but the jurisdiction is fragmented, and at best the regulatory agencies can only make educated guesses about whether balance sheets are strong enough to withstand pressures when novel and exotic instruments create market conditions that cannot be anticipated by models.

A last parallel is ideological -- the nearly universal conviction, 80 years ago and today, that markets are so perfectly self-regulating that government's main job is to protect property rights, and otherwise just get out of the way.

We all know the history. The regulatory reforms of the New Deal saved capitalism from its own self-cannibalizing instincts, and a reliable, transparent and regulated financial economy went on to anchor an unprecedented boom in the real economy. Financial markets were restored to their appropriate role as servants of the real economy, rather than masters. Financial regulation was pro-efficiency. I want to repeat that, because it is so utterly unfashionable, but it is well documented by economic history. Financial regulation was pro-efficiency. America's squeaky clean, transparent, reliable financial markets were the envy of the world. They undergirded the entrepreneurship and dynamism in the rest of the economy.

Beginning in the late 1970s, the beneficial effect of financial regulations has either been deliberately weakened by public policy, or has been overwhelmed by innovations not anticipated by the New Deal regulatory schema. New-Deal-era has become a term of abuse. Who needs New Deal protections in an Internet age?

Of course, there are some important differences between the economy of the 1920s, and the one that began in the deregulatory era that dates to the late 1970s. The economy did not crash in 1987 with the stock market, or in 2000-01. Among the reasons are the existence of federal breakwaters such as deposit insurance, and the stabilizing influence of public spending, now nearly one dollar in three counting federal, state, and local public outlay, which limits collapses of private demand.

But I will focus on just one difference – the most important one. In the 1920s and early 1930s, the Federal Reserve had neither the tools, nor the experience, nor the self-confidence to act decisively in a credit crisis. But today, whenever the speculative excesses lead to a crash, the Fed races to the rescue. No, it doesn't bail our every single speculator (though it did a pretty good job in the two Mexican rescues) but it bails out the speculative system, so that the next round of excess can proceed. And somehow, this is scored as trusting free markets, overlooking the plain fact that the Fed is part of the U.S. government.

When big banks lost many tens of billions on third world loans in the 1980s, the Fed and the Treasury collaborated on workouts, and desisted from requiring that the loans be marked to market, lest several money center banks be declared insolvent. When Citibank was under water in 1990, the president of the Federal Reserve Bank of New York personally undertook a secret mission to Riyadh to persuade a Saudi prince to pump in billions in capital and to agree to be a passive investor.

In 1998, the Fed convened a meeting of the big banks and all but ordered a bailout of Long Term Capital Management, an uninsured and unregulated hedge fund whose collapse was nonetheless putting the broad capital markets at risk. And even though Chairman Greenspan had expressed worry two years (and several thousand points) earlier that "irrational exuberance" was creating a stock market bubble, big losses in currency speculation in East Asia and Russia led Greenspan to keep cutting rates, despite his foreboding that cheaper money would just pump up markets and invite still more speculation.

And finally in the dot-com crash of 2000-01, the speculative abuses and insider conflicts of interest that fueled the stock bubble were very reminiscent of 1929. But a general depression was not triggered by the market collapse, because the Fed again came to the rescue with very cheap money.

So when things are booming, the financial engineers can advise government not to spoil the party. But when things go bust, they can count on the Fed to rescue them with emergency infusions of cash and cheaper interest rates.

I just read Chairman Greenspan's fascinating memoir, which confirms this rescue role. His memoir also confirms Mr. Greenspan's strong support for free markets and his deep antipathy to regulation. But I don't see how you can have it both ways. If you are a complete believer in the proposition that free markets are self-regulating and self-correcting, then you logically should let markets live with the consequences. On the other hand, if you are going to rescue markets from their excesses, on the very reasonable ground that a crash threatens the entire system, then you have an obligation to act pre-emptively, prophylactically, to head off highly risky speculative behavior. Otherwise, the Fed just invites moral hazards and more rounds of wildly irresponsible actions.

While the Fed and the European Central Bank were flooding markets with liquidity to prevent a deeper crash in August and September, the Bank of England decided on a sterner course. It would not reward speculators. The result was an old fashioned run on a large bank, and the Bank of England changed its tune.

So the point is not that the Fed should let the whole economy collapse in order to teach speculators a lesson. The point is that the Fed needs to remember its other role – as regulator.

One of the odd things about the press commentary about what the Fed should do is that it has been entirely along one dimension: a Hobson's choice: – either loosen money and invite more risky behavior, or refuse to enable asset bubbles and risk a more serious credit crunch – as if these were the only options and monetary policy were the only policy lever. But the other lever, one that has fallen into disrepair and disrepute, is preventive regulation.

Mr. Chairman, you have had a series of hearings on the sub-prime collapse, which has now been revealed as a textbook case of regulatory failure. About half of these loans were originated by non-federally regulated mortgage companies. However even those sub-prime loans should have had their underwriting standards policed by the Federal Reserve or its designee under the authority of the 1994 Home Equity and Ownership Protection Act. And by the same token, the SEC should have more closely monitored the so called counterparties—the investment and commercial banks—that were supplying the credit. However, the Fed and the SEC essentially concluded that since the paper was being sold off to investors who presumably were cognizant of the risks, they did not need to pay attention to the deplorable underwriting standards.

In the 1994 legislation, Congress not only gave the Fed the authority, but directed the Fed to clamp down on dangerous and predatory lending practices, including on otherwise unregulated entities such as sub-prime mortgage originators. However, for 13 years the Fed stonewalled and declined to use the authority that Congress gave it to police sub-prime lending. Even as recently as last spring, when you could not pick up a newspaper's financial pages without reading about the worsening sub-prime disaster, the Fed did not act—until this Committee made an issue of it.

Financial markets have responded to the 50 basis-point rate-cut, by bidding up stock prices, as if this crisis were over. Indeed, the financial pages have reported that as the softness in housing markets is expected to worsen, traders on Wall Street have inferred that the Fed will need to cut rates again, which has to be good for stock prices.

Mr. Chairman, we are living on borrowed time. And the vulnerability goes far beyond the spillover effects of the sub-prime debacle.

We need to step back and consider the purpose of regulation. Financial regulation is too often understood as merely protecting consumers and investors. The New Deal model is actually a relatively indirect one, since it relies more on mandated disclosures, and less on prohibited practices. The enormous loopholes in financial regulation—the hedge fund loophole, the private equity loophole, are justified on the premise that consenting adults of substantial means do not need the help of the nanny state, thank you very much. But of course investor protection is only one purpose of regulation. The other purpose is to protect the system from moral hazard and catastrophic risk of financial collapse. It is this latter function that has been seriously compromised.

HOEPA was understood mainly as consumer protection legislation, but it was also systemic risk legislation.

Sarbanes-Oxley has been attacked in some quarters as harmful to the efficiency of financial markets. One good thing about the sub-prime calamity is that we haven't heard a lot of that argument lately. Yet there is still a general bias in the administration and the financial community against regulation.

Mr. Chairman, I commend you and this committee for looking beyond the immediate problem of the sub-prime collapse. I would urge every member of the committee to spend some time reading the Pecora hearings, and you will be startled by the sense of déjà vu.

I'd like to close with an observation and a recommendation.

My perception as a financial journalist is that regulation is so out of fashion these days that it narrows the legislative imagination, since politics necessarily is the art of the possible and your immediate task is to find remedies that actually stand a chance of enactment. There is a vicious circle – a self-fulfilling prophecy -- in which remedies that currently are legislatively unthinkable are not given serious thought. Mr. Chairman, you are performing an immense public service by broadening the scope of inquiry beyond the immediate crisis and immediate legislation.

Three decades ago, a group of economists inspired by the work of the late Milton Friedman created a shadow Federal Open Market Committee, to develop and recommend contrarian policies in the spirit of Professor Friedman's recommendation that monetary policy essentially be put on automatic pilot. The committee had great intellectual and political influence, and its very existence helped people think through dissenting ideas. In the same way, the national security agencies often create Team B exercises to challenge the dominant thinking on a defense issue.

In the coming months, I hope the committee hears from a wide circle of experts – academics, former state and federal regulators, financial historians, people who spent time on Wall Street – who are willing to look beyond today's intellectual premises and legislative limitations, and have ideas about what needs to be re-regulated. Here are some of the questions that require further exploration:

First, which kinds innovations of financial engineering actually enhance economic efficiency, and which ones mainly enrich middlemen, strip assets, appropriate wealth, and increase systemic risk? It no longer works to assert that all innovations, by definition, are good for markets or markets wouldn't invent them. We just tested that proposition in the sub-prime crisis, and it failed. But which forms of credit derivatives, for example, truly make markets more liquid and better able to withstand shocks, and which add to the system's vulnerability. We can't just settle that question by the all purpose assumption that market forces invariably enhance efficiency. We have to get down to cases.

The story of the economic growth in the 1990s and in this decade is mainly a story of technology, increased productivity growth, macro-economic stimulation, and occasionally of asset bubbles. There is little evidence that the growth rates of the past decade and a half – better than the 1970s and '80s, worse than the 40's, 50's and '60s -- required or benefited from new techniques of financial engineering.

I once did some calculations on what benefits securitization of mortgage credit had actually had. By the time you net out the fee income taken out by all of the middlemen – the mortgage broker, the mortgage banker, the investment banker, the bond-rating agency – it's not clear that the borrower benefits at all. What does increase, however, are the fees and the systemic risks. More research on this question would be useful. What would be the result of the secondary mortgage market were far more tightly subjected to standards? It is telling that the mortgages that best survived the meltdown were those that met the underwriting criteria of the GSE's.

Second, what techniques and strategies of regulation are appropriate to damp down the systemic risks produced by the financial innovation? As I observed, when you strip it all down, at the heart of the recent financial crises are three basic abuses: lack of transparency; excessive leverage; and conflicts of interest. Those in turn suggest remedies: greater disclosure either to regulators or to the public. Requirement of increased reserves in direct proportion to how opaque and difficult to value are the assets held by banks. Some restoration of the walls against conflicts of interest once provided by Glass Steagall. Tax policies to discourage dangerously high leverage ratios, in whatever form.

Maybe we should just close the loophole in the 1940 Act and require of hedge funds and private equity firms the same kinds of disclosures required of others who sell shares to the public, which in effect is what hedge funds and private equity increasingly do. The industry will say that this kind of disclosure impinges on trade secrets. To the extent that this concern is valid, the disclosure of positions and strategies can be to the SEC. This is what is required of large hedge funds by the Financial Services Authority in the UK, not a nation noted for hostility to hedge funds. Indeed, Warren Buffet's Berkshire Hathaway, which might have chosen to operate as private equity, makes the same disclosures as any other publicly listed firm. It doesn't seem to hurt Buffett at all.

To the extent that some private equity firms and strategies strip assets, while others add capital and improve management, maybe we need a windfall profits tax on short term extraction of assets and on excess transaction fees. If private equity has a constructive role to play—and I think it can—we need public policies to reward good practices and discourage bad ones. Industry codes, of the sort being organized by the administration and the industry itself, are far too weak.

Why not have tighter regulation both of derivatives that are publicly traded and those that are currently regulated – rather weakly-- by the CFTC: more disclosure, limits on leverage and on positions. And why not make OTC and special purpose derivatives that are not ordinarily traded (and that are black holes in terms of asset valuation), also subject to the CFTC?

A third big question to be addressed is the relationship of financial engineering to problems of corporate governance. Ever since the classic insight of A.A. Berle and Gardiner Means in 1933, it has been conventional to point out that corporate management is not adequately responsible to shareholders, and by extension to society, because of the separation of ownership from effective control. The problem, if anything, is more serious today than when Berle and Means wrote in 1933, because of the increased access of insiders to financial engineering. We have seen the fruits of that access in management buyouts, at the expense of both other shareholders, workers, and other stakeholders. This is pure conflict of interest.

Since the first leveraged buyout boom, advocates of hostile takeovers have proposed a radically libertarian solution to the Berle-Means problem. Let a market for corporate control hold managers accountable by buying, selling, and recombining entire companies via LBOs that tax deductible money collateralized by the target's own assets. It is astonishing that this is even legal, let alone rewarded by tax preferences, even more so when managers with a fiduciary responsibility to shareholders are on both sides of the bargain.

The first boom in hostile takeovers crashed and burned. The second boom ended with the stock market collapse of 2000-01. The latest one is rife with conflicts of interest, it depends heavily on the perception that stock prices are going to continue to rise at multiples that far outstrip the rate of economic growth, and on the borrowed money to finance these deals that puts banks increasingly at risk.

So we need a careful examination of better ways of holding managers accountable – through more power for shareholders and other stakeholders such as employees, proxy rules not tilted to incumbent management, and rules that reward mutual funds for serving as the agents of shareholders, and not just of the profit maximization of the fund sponsor. John Bogle, a pioneer in the modern mutual fund industry, has written eloquently on this.

Interestingly, the intellectual fathers of the leveraged buyout movement as a supposed source of better corporate governance, have lately been having serious second thoughts. Michael Jensen, one of the original theorists of efficient market theory and the so called market for corporate control and an advocate of compensation incentives for corporate CEOs has now written a book calling for greater control of CEOs and less cronyism on corporate boards. That cronyism, however, is in part a reflection of Jensen's earlier conception of the ideal corporation.

I don't have all the answers on regulatory remedies, but people smarter than I need to systematically ask these questions, even if they are beyond the pale legislatively for now. And there are scholars of financial markets, former state and federal regulators, economic historians, and even people who did time on Wall Street, who all have the same concerns that I do as well as more technical expertise, and who I am sure would be happy to find company and to serve.

One last parallel: I am chilled, as I'm sure you are, every time I hear a high public official or a Wall Street eminence utter the reassuring words, "The economic fundamentals are sound." Those same words were used by President Hoover and the captains of finance, in the deepening chill of the winter of 1929-1930. They didn't restore confidence, or revive the asset bubbles.

The fact is that the economic fundamentals **are** sound – if you look at the real economy of factories and farms, and internet entrepreneurs, and retailing innovation and scientific research laboratories. It is the financial economy that is dangerously unsound. And as every student of economic history knows, depressions, ever since the South Sea bubble, originate in excesses in the financial economy, and go on to ruin the real economy.

It remains to be seen whether we have dodged the bullet for now. If markets do calm down, and lower interest bail out excesses once again, then we have bought precious time. The worst thing of all would be to conclude that markets self corrected once again, and let the bubble economy continue to fester. Congress has a window in which restore prudential regulation, and we should use that window before the next crisis turns out to be a mortal one.