The Financial Crisis Inquiry Commission

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Introduction

Chairman Bachus, Ranking Member Frank and Members of the Committee, I am pleased to have the opportunity to appear today. In your invitation, you asked that I address three areas:

- The findings of the FCIC's Majority and Minority final reports;
- My assessment of the Dodd-Frank Act in light of these findings; and
- The reasons for the Commission's inability to reach consensus on a single set of findings with regard to the causes of the financial crisis.

I am pleased to have the opportunity to comment on all three aspects of this hearing.

FCIC Findings

No abridged version of the Majority or Minority reports can substitute for a reading of the full documents. In particular, the dissent authored by Vice-Chairman Thomas, Commissioner Hennessey, and myself is concise enough that I encourage Members to read it in its entirety. (See http://americanactionforum.org/sites/default/files/Dissent%20-%20Hennessey%2C%20Holtz-Eakin%20and%20Thomas.pdf.)

Our conclusions differ from those of the majority and the dissent of Commissioner Wallison in three important ways. First, we depart from the other statements' simplistic narratives – either "it's the fault of Wall Street greed" or "it's only about

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* The opinions expressed herein are mine alone and do not represent the position of the American Action Forum. I am grateful to Cameron Smith, Michael Ramlet, and Matt Thoman for assistance.

government housing policy" – in favor of a more precise, if less media-friendly, identification of 10 specific causes of the crisis:

1. A Credit bubble.
2. A Housing bubble.
3. Nontraditional mortgages.
4. Credit ratings and securitization.
5. Financial institutions concentrated correlated risk.
6. Too much leverage and liquidity risk.
7. Risk of contagion.
8. Exposure to a common housing shock.
9. Financial shock and panic.
10. Transmission of financial crisis to an economic downturn.

I would be happy to elaborate on any of these 10 factors.

A second key difference among the findings is our global orientation instead of the U.S.-centric approaches in the other reports. We believe that the bursting of a global credit and housing bubble was the triggering event that started this nation toward its financial crisis. Because those bubbles had a global scope, they belie an exclusive focus on either U.S. housing policy, U.S. monetary policy, or the motivations of U.S. financial sector executives. More generally, we think that to meet the mandate Congress set for the Commission – a full understanding of the causes of the financial and economic crisis – one must think more broadly than evidenced in the other reports.

Similarly, in the United Kingdom the government was forced to bail out Northern Trust in a manner reminiscent of U.S. financial intervention, despite the fact that the Financial Services Authority constituted a wholly different regulatory regime than in the United States. This global episode is important evidence that argues against the notion that it was the U.S. regulatory regime that was at fault. Our report and reasoning is heavily influenced by this kind of reasoning.

Finally, our dissent places the focus more on broad economic forces and financial structures, and less on specific institutions or individuals. Again, we did so because we felt it best met the mandate Congress set for us.

Reasons for Inability to Find Consensus

The failure to reach agreement on a consensus report has garnered an outsized amount of attention. Let me begin by noting that the FCIC was given a mandate of extraordinary scope and a very short timetable. Even had all 10 Commissioners agreed on every issue each and every day, we would have run the risk of not satisfying Congress in our response to its charge. And it is not surprising that there existed disagreements. After all, experts continue to investigate, argue about, and disagree over the causes of the Great Depression seven decades after it ended.

However, a review of the key differences in the three reports is an insight into the failure to reach consensus. Simply put, we were unable to bridge the differences with our colleagues in their desire for simple narratives; focus on specific institutions, individuals, or policies; and a U.S.-centric approach to the evidence.

Implications for the Dodd-Frank Legislation

Taken at face value, a purpose of the FCIC was to provide a roadmap for the statutory changes needed to address, at least in part, the causes of the financial crisis. And despite the fact that its passage preceded the final reports of the FCIC by several months many have interpreted the Dodd-Frank legislation as the response to the financial crisis. However, there is no neat one-to-one correspondence between the crisis, the FCIC, and the law.

There are areas that have nothing to do with the financial crisis that might merit reforms in financial regulation. For example, only a handful of derivatives (complex mortgage-based securities and credit-default swaps at AIG) were involved in the crisis, leading me to disagree with the notion that "derivatives caused the financial crisis" that pervades the majority reasoning. The vast majority of index futures, oil futures, interest rate swaps, currency futures, and the myriad other financial derivatives had *nothing* to do with the crisis in 2008. Nevertheless, I have agreed with the notion that it would be an improvement to trade some of these instruments through the use of clearinghouses or exchanges. Similarly, the continued failure to merge the Securities and Exchange Commission and the Commodity Futures Trading Commission is a baffling affront to regulatory common sense. The former was done (and, perhaps, overdone) in Dodd-Frank while the latter continues forward. But neither would be a response to the financial crisis.

However, there are a few areas in which consideration of the findings of the FCIC (or at least *my* findings) do shape one's view of Dodd-Frank. To begin, we found that origination of nontraditional mortgages was a contributing cause to the financial crisis. And, as we stress in our report, there were unquestionably bad mortgages made with bad intent by bad people. But other countries had housing bubbles without the same array of sub-prime, alt-A, negative amortization, and other exotic mortgages that have been the focus in the United States. And, despite repeated public comments about the importance of fraud, the FCIC majority was never able to provide a single piece of evidence about its quantitative contribution to mortgage origination.

Accordingly, one has to downgrade claims of a massive regulatory failure regarding mortgage origination, and be skeptical of broader claims regarding the need for different regulation of consumer transactions. For this reason, I do not support the creation of the Consumer Financial Protection Agency included in Dodd-Frank. And

I am surprised that Congress would choose to create such an agency and place it beyond the standard oversight provided by funding through the budget process.

Similarly, our investigation showed no contribution from the repeal of Glass-Steagall to the financial crisis. For this reason, I do not think that rulemaking to impose the so-called Volcker will generate a valuable contribution to the regulatory environment.

Next, our investigation delved at length into the issue of "too-big-to-fail" institutions. One fact that seems to have been largely overlooked is that institutions were deemed too-big-too-fail around the globe and not just in the United States. Thus, for example, even in the United Kingdom, which had both an integrated regulatory body and a mandate for systemic risk regulation, the phenomenon prevailed. Accordingly, I do not believe that the array of features in Dodd-Frank effectively resolves the large amount of moral hazard in the U.S. financial system.

Lastly, one of the strong, if obvious, lessons is that financial markets interact with the real, Main-street economy. The crushing financial crisis of 2008 drove a weak economy into a deep recession. As the macroeconomy struggles to reach a robust recovery, the same lesson should be remembered. The hundreds of new rules that must be promulgated in Dodd-Frank are a lingering uncertainty that cannot be anything but a drag on the financial sector. The scope and haste of the rule-making will inevitably yield rules that would fail a true benefit-cost test. And when combined with the regulatory expansions in the Environmental Protection Agency and under the Patient Protection and Affordable Care Act, the result is a massive regulatory expansion that will burden businesses large and small, harm job creation and slow the recovery from this painful recession.

Conclusion

Thank you for the chance to offer this brief written statement. I would be happy to elaborate in areas that you find interesting and look forward to answering your questions.

COMMITTEE ON EDUCATION AND THE WORKFORCE
U.S. HOUSE OF REPRESENTATIVES

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3. Please list any offices or elected positions held and/or briefly describe your representational capacity with each of the entities you listed in response to question 2:	
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