

Oral Testimony of Mark Zandi
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Before the House Financial Services Committee

*"Systemic Risk: Are Some Institutions too Big to Fail, and if so,
What Should We Do About It?"*

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Mr. Chairman and members of the committee, thank you for the opportunity to testify on such an important matter in a time of economic and financial crisis. I am employed by the Moody's Corporation, but my remarks reflect my personal views.

I will make five points in my remarks:

1) The Obama administration's proposed financial regulatory reform is much-needed and reasonably well-designed. The panic that was roiling the financial system just a few months ago has subsided, but the system remains in significant disrepair, as credit remains severely impaired. Until credit flows more freely, a self-sustaining economic expansion will not take hold. Regulatory reform is vital to restoring confidence in the financial system and thus to fully reviving it and the economy. The administration's proposed regulatory framework fills most of the holes in the current one, and although the proposed system would not have prevented the current crisis, it would have made it less severe. More importantly, the proposed framework would reduce the odds and severity of future financial crises.

2) A key aspect of the proposed reform is establishing the Federal Reserve as a systemic risk regulator. The Fed is uniquely suited for this task, given its central position in the global financial system, its significant financial and intellectual resources, and its history of political independence. As a systemic risk regulator, the Fed can address the age-old problem that financial regulation tends to be procyclical, reinforcing changes in creditors' underwriting standards and thus the availability of credit. As a systemic risk regulator, the Fed would also have a responsibility and the ability to prevent asset bubbles, something it has failed to do. There were good reasons for this reluctance, but as this crisis has demonstrated, there are better reasons to take action. As a systemic regulator, the Fed could influence the amount of leverage and risk-taking in the financial system—essential ingredients in the making of a bubble.

3) Establishing a new Consumer Financial Protection Agency with the authority to protect consumers of financial products is a good idea. As is clear from the current crisis, consumers have limited understanding of their obligations as borrowers or the risks they take as investors. The idea of a new agency has come under substantial criticism from financial institutions that fear it will stifle their ability to create new financial products and raise the costs of providing existing ones. The new agency will not get it right all the time, but it will help ensure that consumers get what they pay for. The Federal Reserve also seems reluctant to let go of its authority in setting regulatory policy in this area. But the Fed has historically given its oversight of consumer financial products short-shrift compared with its more weighty responsibilities, which would get even weightier with this proposed reform.

4) The reform proposal does have some significant limitations. First, it does not seriously work to rationalize the current alphabet soup of federal and state financial system regulators. Regulatory arbitrage will thus remain a serious problem. Second, the reform proposal does not adequately identify the lines of authority among regulators and the mechanisms for resolving differences. It does not appear that the proposed Financial Services Oversight Council would be

5) The crisis has shown that an uncomfortably large number of financial institutions are too big to fail. That is, their failure risks undermining the system, giving policymakers little choice but to intervene. The desire to break up these institutions is understandable but ultimately futile. There is no going back to the era of Glass-Steagall; breaking up the banking system's mammoth institutions would be too wrenching and would put U.S. institutions at a distinct competitive disadvantage vis-à-vis their large global competitors. Large financial institutions are also needed to finance and backstop the rest of the financial system. It is more efficient and practical for regulators to watch over these large institutions and, by extension, the rest of the system. With the Fed as the systemic risk regulator, more effective oversight of too- big-to-fail institutions would be possible. These large institutions should also be required to hold more capital, satisfy stiffer liquidity requirements, be subject to greater disclosure requirements, and pay deposit and perhaps other insurance premiums commensurate with the risks they take and pose to the entire financial system.

The proposed financial system regulatory reforms are as wide-ranging as any implemented since the Great Depression. The reforms are generally well-balanced, and if they were largely implemented, they would result in a more steadfast albeit slower-paced financial system. The administration's reform proposal does not address a wide range of vital questions, from the role of the rating agencies to how to regulate institutions that are deemed too big to fail. It is only appropriate that these questions be answered by legislators and regulators after careful deliberation, and just how they are answered will ultimately determine how well reform efforts succeed.