REMARKS GIVEN AT BOSTON UNIVERSITY SCHOOL OF LAW ON THE CREDIT CRISIS

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Thank you. I am flattered to be invited and eager to begin—in some cases continue, with some friends and others in the audience—an important dialog. Let me cut right to it: There is now, I believe, a consensus that we have to make some significant changes in the nature and scope of financial regulation. There is, understandably, less agreement on what it should be. But getting to the point where people do agree that we need some has been a major step. And I'm going to talk about that, and then talk about the directions that we hope to be going in.

I noticed that the Morin Center is an institute for banking and financial law. Part of the problem, of course, has been the banking that was done outside the law. Not in an illegal sense, but in a non-legal sense. I first began to work with people in the banking business from the public policy standpoint in 1972 when I was first elected to the Legislature, and I remember bankers telling me their mantra was "know your borrower." Well, today, not only do the people who make the loans not know their borrower, they have no idea who their borrower is. And, in fact, their borrower is maybe one tenth of one percent of a whole lot of people.

There has been a fundamental change, and I believe that what we've seen is a case for sensible regulation. I was going to give a speech about a month ago, and it was snowed out. And I'm looking to redo it. I'll give you part of it now. The title was *We Told You So: A Liberal Looks at Contemporary Capitalism*.

People tell little fibs, and one of the fibs often told is, "Oh, I don't like to say 'I told you so.'" Everybody likes to say, "I told you so." And I will tell you that it is one of the few pleasures that improves with age. I can say, "I told you so," and I don't have to take a pill before I do it, while I'm doing it, or after I do it. I can just say it. And there was something prevalent in the world for a while—and I mean the world, not just the U.S., but the World Bank, the International Monetary Fund, something called the Washington Consensus. It was politically and intellectually somewhat dominant. It was the Ronald Regan philosophy of governance, and it was increasingly strong in academic departments of economics.

You would see it in the financial pages of the newspapers, and the general notion was that government was doing more harm than good much of the time, and that the market could be left to its own. This was the dominant political philosophy in the Congress from 1994 until last year. Dick Armey, a Ph.D economist and one of the leading republican economic spokesmen as Majority Leader of the House, had a motto: "Government is dumb. Markets are smart." The Washington Consensus consisted of telling countries throughout the world, including poor countries, that they needed to balance their budgets and cut back on subsidies for the poor.

The World Bank today still puts out a report called *Doing Business*, in which the easier it is to fire people, and the less vacation time workers get, the better you look from the standpoint of doing business. It seems to be a very outdated way to go. Saudi Arabia beats Finland on this scale.

What we were told was, and this is not long ago, ten, fifteen months ago back to November of 2006, you have the report that has been commissioned by Mayor Bloomberg and Senator Schumer. You have the report from Hal Scott at Harvard Law School, known as the Paulson Report. And the argument was, listen America, you better deregulate your financial institutions in particular, or everybody's going overseas. People are going to go to England where

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[1] Rep. Barney Frank gave these remarks at Boston University School of Law on February 11, 2008. Rep. Frank serves Massachusetts's fourth congressional district, and he is the Chairman of the House Financial Services Committee.

they can have the financial service authority treat them nicely. IPOs aren't going to be done in America anymore. And the dominant view that I encountered, literally fifteen months ago was, you are over-regulating in America and you better cut back.

Today things are very different. Obviously there are areas where we can make regulation more sensible. But we are now in the midst of one of the most serious economic crises we have seen in recent years. Clearly from the worldwide standpoint, the worst economic crisis since more than ten years ago, '97 and '98, the Asian and Russian financial crises. And inadequate regulation is one of the major causes. People were worried about America being overregulated. If you look now in the financial area, one of our major exports over the past year turns out to have been bad mortgages. The notion that America must deregulate seems less clear to people.

The important issue is what happened. And we have two aspects that we have to deal with. One, how do we deal with the current negative impacts? And two, what do we do to diminish the likelihood that this recurs? As I look at this, one relevant fact is that about a month ago Citigroup announced a reorganization of its mortgage department, and they had two separate entities: one that dealt with securitized mortgages and one that dealt with mortgages that had been originated in their banks. They have merged the two. And they noted that the record of the securitized mortgages was much worse than the record of the mortgages that have originated in the banks.

Twenty years ago or more, the overwhelming majority of residential mortgages were made by regulated depository institutions. Basically you had banks and thrift institutions that took funds from depositors, and because they were funds taken by depositors, they were fairly heavily regulated, by either state or federal regulators, or both.

Bank examiners would come around, and if you had made a lot of loans to people who had no remote chance of paying them back, you would have some explaining to do to the bank examiners. And you had to know your borrower. Over this past couple decades, and I don't know exactly when it happened, a competing form of mortgage origination grew up. Initially, people lent money and then expected to be paid back. The banks held the mortgages. And when you lent the money, you expected people to pay you back. And you also were lending with depository funds, so people were checking on you.

Increasingly, in recent years, loans are made with funds that were not given by depositors. Pools of money grew up for a variety of reasons that were available for loans. And loan originators grew up, who were outside the banking system, and who were making the loan with the purpose of selling it—so that you increasingly have loans now made by people who make the loan, sell it, get their money, and have no further need to worry about it. That's securitization. And it has a lot of advantages.

Secretary Paulson has turned out to be, I think, a very responsible, important, and constructive partner for the Congress. We've had three Secretaries of the Treasury under this administration, and I'm now prepared to go out on a limb and say that having been in the financial sector, as Secretary Paulson was, is better preparation for being Secretary of Treasury than either aluminum or railroads. He has said, and Ben Bernanke has said, we have these good and bad aspects of our situation. There is a tendency for innovation to outstrip regulation. Now innovation is obviously a good thing, and to some extent innovation is self-policing, because if you come up with a brand new idea and it doesn't produce any real value to people, it's going to sink of its own weight. Innovations that do not add to the ability of people to profit don't go anywhere. The problem, though, is, and it's what we've seen with securitization, innovation can outstrip regulation.

We have a lot of sensible regulation that applies when banks make mortgages with depository funds. We have virtually no regulation, it turns out, when mortgage brokers go to pools of money and make loans in that way. And it is not that mortgage brokers are inherently morally less trustworthy than bankers; the difference here is whether or not there is sensible regulation. And what's happened with securitization is that an increasing number of loans were

made by people who did not have to worry about being paid back by the borrower. And it turns out that that lender/borrower relationship imposed a discipline in the financial system that we had undervalued.

Now we were told that, "Oh, this is going to be replaced." How do we replace the discipline of a lender/borrower relationship? Well, by something called "risk management." And risk management could be very complicated. It involves very arcane quantitative models, which I readily acknowledge that I don't understand. The fact that I didn't understand the quantitative models that were providing risk management was not as big a problem, apparently, as the fact that the people who were running them didn't understand them either.

And in consequence, they didn't know what they had and what they didn't have. This is the issue for us. It's a specific issue, but it's an example of a generic issue in the regulatory field. How do you allow an innovation to flourish and give you the benefits that people have come up while diminishing the abuses? You obviously never hit the optimal point where nothing bad happens, and only good things happen. But you can bring it closer to that goal. And it's not just an issue in sub-prime mortgages, although that's a current crisis, but we see this in other areas. How do you get the benefits of people being able to securitize loans, and therefore increase their capacity to make loans, and increase liquidity, while replacing the discipline of the lender/borrower relationship?

How does the system allow people to make a lot more loans while reducing the quantity of bad loans they make? Part of risk management was to be diversification. There may be a few bad loans, but they're going to be diversified. But it turns out if you put enough bad stuff into the system, diversification does not help you. It spreads the problem. And that's what we're doing. Now, I will give you some tentative suggestions. People say, "Well, it's just hindsight." No.

As a liberal, I can say, "We told you so." Many on the liberal side, including myself, certainly agree that too much regulation can be a problem. But we've also tried to argue that too little regulation can also be a problem. We were on the defensive on that. Another example of my feeling vindicated is the question of income distribution. For years, many of us on the liberal side have been arguing that the free market system, which is a great way to create wealth, could create wealth in a way that exacerbates inequality. Obviously you need inequality in a capitalist system. It's necessary, it's a good thing. But too much of it is not. And we were dismissed on that. Included in the mainstream journalism—you go back ten years, and you would see in the financial pages of *The New York Times*, generally a liberal newspaper, a good news/bad news story about the economy.

The good news was that profits had gone up. The bad news, wages had gone up. And it was bad news when wages went up, even if wages were going up less than inflation. They've sort of corrected that now. The minimum wage is an example. Fifteen years ago, there was a pretty strong consensus in the academic economics departments that those of us pushing for increased minimum wage were just pandering. We meant well, but it was not going to work. There's been a reversal—recognition by many economists that, in fact, in the right conditions raising the minimum wage has no negative affect on unemployment. And you don't hear people now dismissing our concerns about the tendency of this economy to concentrate wealth. It's no longer being dismissed as class warfare.

As recently as the 2004 Presidential campaign, John Kerry was somewhat inhibited from raising these economic issues because they said you were engaging in class warfare. I think the best thing to answer that came from Warren Buffet, who said, "Oh, yes, we have class warfare in America. My class is winning."

The statistics are now overwhelming. Don Evans who was Secretary of Commerce under George Bush, and a close friend of the President, released a report a couple months ago documenting that in the last several years only 5% of the population has gotten increases in compensation in real terms. That other 95% have gotten either nothing, or in many cases, more

people have had an erosion rather than a gain. This is a major issue on which the parties differ strongly.

But I will tell you these days that I indeed find myself much more open to defending myself as a partisan. There is this denunciation of partisanship. We're supposed to be post-partisan. And I will tell you that as I listen to some of this debate, I suffer from post-partisan depression.

The fact is that there has never been in the history of the world a self-governing polity of any size where you did not have political parties. Not because anybody created them, but because human beings who try to govern themselves, need some form of organization. And parties in America can mean a great deal. Partisanship can have a bad aspect. It can go too far. It can poison your ability to cooperate when you should be able to cooperate.

Let me give you an example, and it has to deal with sub-prime. In 1994, the last year the democrats had a majority before this current year, Congress passed the Home Owners Equity Protection Act. It empowered the Federal Reserve Board to make rules for mortgages even for institutions that were not banks.

It recognized you had mortgage loans being made outside the banking system. From 1995 until last year, the Federal Reserve explicitly refused to exercise that authority because Mr. Greenspan believed firmly in the power of the market to self-regulate and believed any regulation would be hurtful.

This year the House passed a bill to regulate sub-prime mortgages, and the Federal Reserve under Mr. Bernanke has become active, although not as strong as some of us would like. In 2005, a group of Democratic members of the banking committee, the Finance Service Committee, and one Republican, began talking about a bill to deal with sub-prime abuses. The negotiations were going forward, but not as fast as people would like. They were going forward. And then the Republican leadership in the House ordered them to stop because that was interference with the market.

So there has been this partisan difference. And as I said, I think the evidence is now clear that too little regulation can be damaging, as well as too much regulation. And in particular, when you get great innovations that provide a lot of benefit, the job is not simply to sit back and admire them, but to figure out how regulation can be upgraded so that you get some of these benefits without the abuses. And the key here is in the area of lending. We have got securitization, which gives us great benefits, but diminishes the discipline of the lender/borrower relationship, and we need to know what to do about it.

Now in some areas, what we're going to do about it is simply to say, "You can't make those loans." The House passed a bill, the Senate is going to be acting soon, I hope, that says nobody—whether you're a bank, or a mortgage broker, or anybody with any funds—can make a mortgage loan to people who really don't have much chance of paying it back.

Now, in fact, I believe that is the rule that bank examiners would have imposed on any depository institution if they tried to do otherwise. And, in fact, if you were the one who was going to get paid back, you'd have very little incentive to do that. We've also passed a law that said please don't lend to people—not please, *don't* lend to people—money that's worth a lot more than the house you're taking in collateral.

So I'd say one of the things we're going to do is to apply some rules about what to do and not do. But, obviously, you shouldn't try to regulate by figuring out every bad idea, every bad loan. You can do it in the subprime area, that's a very special case. So we've gone beyond that in what we're thinking about. What we're trying to do is to find some way to give the people who make the loans and then sell them some skin in the game. That's essentially the issue.

One way is to at least have these things put on the balance sheets. Now we run into problems. I asked Chuck Prince, before he left, what was the justification for the Structured Investment Vehicles not being on the balance sheet. He said that, well, if they put them on their balance sheets, they'd be at a disadvantage vis-à-vis the investment institutions that didn't have to

put them on their balance sheets. We are now talking about everybody having to put it on their balance sheets.

One of the things I think we have to confront is this: Congress passed, and the President signed, the bill that repealed Glass-Steagall, removing many of the functional barriers that kept banks and securities firms from doing the same thing. But the regulation hasn't gone up with that innovation. Banks are subject to more regulation than the securities firms with which they're competing.

Whether the funds were given by depositors or not, no longer should have as much importance. And we need to regulate some of these other institutions as well. We also talk about more reserve requirements, not just for banks, but for all institutions. And, again, the notion is how do you replace the discipline of lender/borrower by a set of procedures that build in incentives to be more careful?

I know there's one idea, especially radical, and it comes from Martin Wolf of the *Financial Times*, who says he believes one problem is that the financial incentives built into the compensation of the top executives of the financial institution promotes too much risk-taking because they have a one-way ratchet. If they take risks and they pay off, they get a lot more money. If they take a lot of risks and they don't pay off, one of two things happen, either nothing, or they leave with a lot of money. And the disincentives for taking risks that fail aren't there.

So we are clearly in the area of needing to do more regulation. And that also means, I believe—and it's long since past due—we've got to enhance the ability of the regulatory entities to do their job, and pay well for the people there. Now at the same time, there are areas of deregulation that make sense. I have been very supportive of the decision by the Securities and Exchange Commission, or the work by the Securities and Exchange Commission and the European Union, to have convergence in the regulations. One of the things that they're in the process of doing is saying that we will accept each other's accounting. Many thought that we'd have a problem with the two different forms of accounting. One argument was to come up with a common accounting method, but that would take forever, and just, I think, bog down the regulators. Instead what we have is a very sensible motion that European and American regulators will accept, I believe, each other's accounting.

I was supportive when the SEC just cut back on the extent to which you needed to do certain things to comply with Section 404 of Sarbanes-Oxley. The law makes sense, but in the implementation we went too far. It violated a very important principle of human life: never ask your barber if you need a haircut.

It's not that people are selfish, it is that all of us like to believe that what we do is important. There is a tendency for all of us to overstress the importance of the contribution we make to the sum of human happiness. And need to be able to check. So it is possible for us to deregulate some areas, and regulate in others. I'll give you another area where I want to deregulate. After 2001, we passed legislation requiring the banks to send us suspicious activity reports. They go to the Financial Crimes Enforcement Network, and as the Financial Services Roundtable told me, they got a million per year. I don't think there's a federal agency capable of handling a million anything. Essentially what we've done in the area of investment crime is tell the law enforcement people to find some needles, and then we build them the hugest haystacks imaginable. We are trying to thin out the amount of paper that has to be sent by the banks.

So it is not that we've given up on cutting back on regulation, but there are some fundamental issues, in which we need to increase the scope of regulation. I do understand that there are people who tell us that by doing that we are going to destroy the markets. You know, we have been arguing, as I say we told you so, that too little regulation can also be a problem, not just too much regulation. And that growth is a good thing. But some public policies are needed to try and prevent growth from happening entirely unequally.

One of the arguments against those positions has been frankly an underestimation of the strength of the capitalist system. We've been told, for instance, that if we let the Bush tax cuts

expire, it would do enormous damage to the capitalist system. If, in fact, we let the Bush tax cuts expire for people in the upper brackets, they will go back to the level that they were at after President Clinton got us to raise them in 1993, after which we had a terrific economy. In fact, some regulation can be helpful. I know people said, "Oh, if you regulate, you're going to destroy things." If you really want to lead the argument that regulation will inevitably be destructive of the free market system, made with passion and eloquence and conviction, go back to the Congressional record in the '30s, and read the debates over the establishment of the Securities and Exchange Commission under Franklin Roosevelt because you hear very much of the same arguments.

The fact is that the capitalist system is a great, free market system, with individuals doing what they do. The economy is much stronger than some of my conservative friends imagine. And I believe that there is a wider range of public policy choices that we can make that will affect income distribution and may affect some other things without endangering the capitalist system one way or the other.

That's where we now are. So you are going to see in the financial services area our view that increased regulation to catch-up with the innovation, particularly in the area of securitization. By the way, that's subsumed. When I took office, I had some friends who said, "Oh, you've got to go after private equity. And you've got to work the hedge funds."

It does not seem to me that—and I think we've been borne out in this—It's not that hedge funds present some new and special difficulty. To the extent that they've participated and helped promote the funding for securitization without the responsibility, yes, they're part of the problem. But it's not the form of the institution that engages in the activity, it is the activity: significant lending followed by selling off the loans and not being able to keep track of who's got what and to whom. That's what we have to deal with.

And our challenge is, as I said, to re-impose the discipline we had before securitization became so widespread without losing the benefits of securitization. Obviously that is more easily conceptualized or said than done, but that's what we will be working on.