Statement of
Senator Susan M. Collins

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

Committee on Homeland Security and Governmental Affairs
January 21, 2009

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The spiraling financial crisis has harmed virtually every American family. December's job losses were the worst monthly decline since 1945 and drove the unemployment rate above seven percent. Individual retirement accounts and college savings accounts, as well as university endowments and public and private pension funds, have suffered huge losses. Consumer credit and mortgage availability have become more restricted.

In the past year, more than a million homes were foreclosed upon, and foreclosure proceedings are targeting two million more. Home prices are still falling,

and at least 14 million households owe more on their mortgages than their homes are worth.

The current crisis has its roots in the financial system, where a combination of low interest rates, reckless lending, complex new instruments, securitization of assets, poor disclosure and understanding of risks, excessive leverage, and inadequate regulation poisoned the normal flows of credit and commerce.

The financial system itself has not escaped the carnage. A year ago, American capital markets were dominated by five large investment banking firms: Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Goldman Sachs. Now they have failed, been sold to banks, or have converted to bank holding companies.

Tens of thousands of banking and investment jobs have disappeared.

A year ago, we thought a TARP was for covering your roof after a hurricane. Now the Troubled Asset Relief Program, originally touted as a means for Treasury to buy troubled assets from banks, has morphed into a mechanism for buying hundreds of billions of dollars in bank preferred stock and warrants.

It is not sufficient for Congress to continue to infuse new money into the TARP, or simply to pass an economic-stimulus package. We must also ask how to repair our system of financial regulation to minimize the risk that another crisis such as this might build up undetected and unchallenged.

As we consider the options for reform, the Government Accountability Office's new report on

financial regulation will be a valuable guidebook. It describes the structure of the current system, explains the system's inability to cope with shifting circumstances, and proposes criteria for judging reforms.

GAO's report sums up our challenge: "As the nation finds itself in the midst of one of the worst financial crises ever, it has become apparent that the regulatory system is ill-suited to meet the nation's needs in the 21st century." That judgment confirms what this Committee has found in hearings on commodity speculation and derivatives trading: There are too many gaps between jurisdictions, too many financial entities and instruments that can create huge risks but are largely free from regulatory requirements, and too little attention paid to systemic risk.

We now understand that every day activities by mortgage brokers, hedge funds, over-the-counter traders, investment banks, Freddie Mac and Fannie Mae, and others dealing in mortgage-backed securities, credit-default swaps, and other instruments can create a crisis that affects virtually every home and business in America.

Yet, of the dozen federal agencies and hundreds of state agencies that are involved in financial regulation, not one is tasked with detecting and assessing systemic risks. We have seen the consequences of that flaw. The proliferation of unregulated and unreported credit-default swaps created spider webs of commitments, so that a few failures rippled into the destruction of major investment banks.

By accident or design, there are many key players in the modern financial-regulatory system who are unregulated or lightly regulated, including mortgage brokers, self-regulating exchanges and credit rating agencies, hedge funds, and nonbank lenders. Without additional transparency into their operations, a new systemic-risk monitor would find its mission difficult to achieve.

These difficulties have become so obvious that it is now common to hear government and industry officials, as well as academic experts, calling for a systemic-risk monitor and for a restructuring of regulatory agencies.

In November, I introduced a bill to correct two other glaring gaps in our regulatory system – the lack of explicit regulatory authority over investment-bank

holding companies and the lack of transparency for credit-default swaps.

Regulatory reform is absolutely essential to restoring public confidence in our financial markets. America's consumers, workers, savers, borrowers, and investors deserve the protection of a new regulatory system that modernizes regulatory agencies, sets safety and soundness requirements for financial institutions to prevent excessive risk-taking, and improves oversight, accountability, and transparency.

Our goals, therefore, must combine several vital objectives: stability for the financial system, safety and soundness regulation for institutions, strict protections for investors and consumers, transparency and accountability for transactions, and increased financial literacy for the public.

In pursuit of these vital objectives, we must also take care not to stifle useful new products, prevent beneficial risk sharing, or create moral hazard by making failure impossible. Some firms deserve to die and have their assets pass into the hands of more capable managers. The challenge is to ease the turmoil caused by failing-but-important institutions without disrupting everything around them. In other words, we need better systems to prevent the development of catastrophic concentrations of risk at firms like Bear Stearns and AIG, and better systems to mitigate the collateral damage if they do fail.

A comprehensive plan of reform with clear goals, a system-wide focus, efficient regulation, flexible and adaptive powers, consistent treatment of parties and products, and minimal exposure for taxpayers may bear little resemblance to the intricate, yet fragmented,

structure that has regulated this country's financial markets for many decades.

Mr. Chairman, America's financial crisis has spread far from Wall Street to affect the livelihoods of people all across America. We all know that people are angry about the crisis, about the failures of regulation, and about the bailouts. They rightly demand that we erect new defenses against a repeat. This hearing will help lay the groundwork for a new, more effective approach to financial regulation.

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