

WRITTEN STATEMENT OF
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Before the
SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

October 16, 2008

Mr. Chairman and members of the Committee, I commend you for your leadership in holding these critically important hearings on the origins and impact of the crisis that is enveloping financial institutions and financial markets worldwide—the most serious since the Great Depression. Understanding the root causes of our predicament will allow us to restore our economy and install a regulatory framework that can withstand the challenges of technology-driven, 21st century finance.

I am honored to testify before your Committee, Mr. Chairman, to contribute my thoughts and to answer any questions you have.

Introduction

The increasingly painful and heart-stopping developments in the U.S. and global financial systems are not the result of mere happenstance. We are in the midst of a historic sea change, particularly in American finance, indeed in the direction of the American economy itself. The paradigm of the last decade has been the conviction that un- or under-regulated financial services sectors would produce more wealth, net-net. If the system got sick, the thinking went, it could be made well through massive injections of liquidity. This paradigm has not merely shifted—it has imploded.

This paradigm implosion is rooted in fundamental imbalances in our economy and financial system, as well as regulatory structures and crisis response mechanisms that are outdated, including importantly:

- Consumerism run riot, made worse by domestic fiscal laxity and modern financing techniques;
- A deterioration in market conduct, brought on by a short-term profitability horizon, aided and abetted by technology and globalization;
- A regulatory hodge-podge involving absent or inadequate regulation of the predominant portion of our financial system and pro-cyclical policies that have not been well conceived; and
- A misguided belief that in financial storms we should let bare knuckled free market capitalism as opposed to compassion and balance rule the day.

By understanding these root causes of our predicament, we can rebuild from the ashes of the current burnout.

Discussion

Rampant Consumerism, Structural Imbalances and Modern Finance: For decades we have looked to the consumer as the key driver of our economy. Taken in proportion this is a good thing. However, this dependence on the consumer has been a losing proposition on its face, given that since 2000, median family income, adjusted for inflation, has been declining. Nevertheless, consumerism has been taken to an extreme, propelled by policies that have resulted in a negative savings rate of historic proportion. Policy makers' excuses that negative savings were not a problem because home prices were rising only caused the consumer to dig a bigger hole for himself. Home and hearth became the consumers' ATM machine as home equity and other consumer loans, leveraged the American consumer to the hilt. Such excess would inevitably lead, as it did, to a financial wildfire.

The actual sparks that ignited the fire began to fly in the early months of 2006. It was at this moment when house prices begin to level off and fall while at the same time there was an explosion in the use and availability of novel, low-quality mortgage instruments designed to “help” consumers pump every dollar possible out of their homes.

Our grandparents’ generation would have recognized the “help” consumers were getting from financiers and from government for what it was. Consumers were not being helped. They were being enticed to mortgage not just their homes but their futures and the future of their children on national and personal deficits based on thin promises. The notion that home prices would climb forever and that we could spend our way to financial and national success was accepted unblinkingly. Interest rates held too low for too long, excess liquidity, and structural fiscal and trade deficits based on an imbalanced tax regime benefited the sellers at the expense of those who really could not afford what they were buying.

And this excess, this lack of sound standards of “buy what you can pay for,” was turbo-charged by the plentiful oxygen of model-driven, structured financial products. Importantly and unfortunately, these highly leveraged products, based on misunderstood and often inaccurate ratings, were distributed throughout the world. Derivatives with even thinner capital bases were in turn piled on top of this mountain of structured products. Acronyms for plain old excessive, under-regulated leverage – SIVs, CDOs, CDOs, squared, swaps, swaptions— lulled us into a false sense of high-tech financial complacency.

Deterioration in Market Conduct: A second major area of failure that brought on the current conflagration has been a marked deterioration over the last several years in market conduct by too many financial services players—mostly, but not only, the un- and under-regulated financial intermediaries. So mortgage brokers sold consumers mortgages that were too often inappropriate for their circumstances in exchange for outsized fees. More heavily regulated financial institutions sliced, diced

and bundled the inappropriate mortgages, selling them off to other intermediaries or end purchasers, feeling no compunction because they held no principal risk.

This turn away from traditional relationship finance based on customer care and high integrity standards has been facilitated in part by the increasing financial use of technology and by globalization. Through increasing speed and scale, the face-to-face linkage to the consumer has been attenuated. This has made rules fashioned for a bygone era harder to apply.

Finance is in many ways an information business and the technological revolution we have been living through has been essentially an information technology revolution. The computer has allowed global connectivity, mathematical/financial modeling, and savings to scale that have created entirely new financial products, and allowed, if not driven, rapid and extraordinary consolidations and concentrations, on a global scale unthinkable a few decades ago. It has also placed financial firms further away from the end-use consumer.

In a sense, technology, plus globalization, plus finance has created something quite new, often called “financial technology.” Its emergence is a bit like the discovery of fire—productive and transforming when used with care, but enormously destructive when mishandled.

Like anything new and dangerous, we should have handled this financial technological fire with great care, with appropriately cautious regulation, with concerns about those—particularly low and moderate income Americans—who were touched by it but by no means understood it. But instead of more cautious regulations in this new more dangerous era, we took the regulatory lid off.

Regulatory Hodge-Podge. Over approximately the last decade the country has been in the thrall of a deregulatory viewpoint which has left us with too few financial regulatory firefighters too far away from where the fire started and where it has burned the hottest. We have allowed a huge portion of our financial system (perhaps as much as 80%) to go un- or under-regulated. Indeed, going into this

crisis, official Washington not only did not know where all the pockets of mortgage-related risk were, they did not know the magnitude of the risk itself.

At the same time, the regulated portion of the system has been unevenly regulated. Some aspects of bank regulation, for example in the anti-money laundering area, have been very heavily regulated with tens of millions of dollars of fines and enforcement actions being piled on enforcement actions for the same wrong. Other aspects of finance, for example, credit standards, securitizations, suitability of products for customer usage, have been markedly less strictly regulated.

To add insult to injury, as a result of history and not logic, we have a bank and securities regulatory system that has been unflatteringly referred to as the “alphabet soup” of regulators. This alphabet soup has exacerbated the problem of overregulation in some areas and created gaping holes in other areas. (For example, the “special investment vehicles” or “SIVs” where a great deal of the bank subprime mortgage risk resided were off-balance sheet bank holding company constructs that essentially went unregulated.)

As if this were not enough, over the past decade we have allowed a number of pro-cyclical and largely untested policies to grow up that are wholly inappropriate and way too rigid. What I mean by “pro-cyclical” is that regulatory, accounting and policy standards and practices tend to move in the same direction as the broader economy. The result is a sort of amplifier effect, in which both good times and the bad times are reinforced as their effects are rapidly transmitted through the economy. One way to think about it is that the failure of our regulatory, accounting and policy standards and practices to exert a moderating influence at all times is what makes the highs so high and the lows so low. While pro-cyclical bias sounds rather abstract, it is a real weakness of our financial system with which policymakers must grapple. In some nations, such as Spain, regulatory policy is deliberately designed to be counter-cyclical, to serve as a countervailing influence on the economy, and these policies merit closer analysis.

How does pro-cyclical bias present itself in clinical terms? We see it in our accounting rules. The concepts around mark-to-market accounting and the relatively recent reliance upon accounting formulas instead of judgments in establishing loan loss reserves clearly added to the financial catastrophe. Mark to market accounting by definition cannot work when markets cease to operate correctly. Likewise, we have relied on rigid new accounting rules and models to set loan loss reserves with a mark-to-market methodology that has left the reserves too thin to do their job in difficult times.

More subtle, but of even greater importance, is the accounting governance mechanism that disconnects accounting rulemaking from business and economic reality, as well as from the public policymaking framework. This has resulted in some rules that run contrary to the time-honored principle that accounting should reflect, not drive, economic reality.

Every bit as important, perhaps more important even than our off-kilter accounting rules and rulemaking, is that our regulators have allowed short-term pressures to rule our financial institutions. Compensation schemes, too, have rewarded executives for short-term results. All of this has forced our financial institutions, their senior executives and their boards to “keep dancing” when times were good even though they knew in their hearts that the music would stop with a thud.

Further, Basel II capital standards, though less of an obvious cause, are certainly not a help in these troubled times. Basel II Pillar 1 is itself too new, too pro-cyclical, too complicated and model-driven. There is no evidence that it in any way helped in this crisis. And there is evidence that it was overly pro-cyclical.

To summarize, gobs of liquidity, consumers on a binge, new highly combustible financial tools, and little effective and overly pro-cyclical regulation has resulted in a financial firestorm. It is as if the modern tools of finance were used to create their magical new fire of finance in the center of a living room, filled with highly combustible furniture, not in a properly designed fireplace.

Response to the Turmoil Too Little Too Late. To add insult to injury, the response to the rising heat of the fire was a series of too little, too late steps based on an ideology that the market could take care of itself. Bureaucracies proved less flexible than was necessary. Our responses to the conflagration were typically taken after the next fire broke out, not before.

The capstone of this initial phase of the effort was the decision to allow Lehman Brothers to fail. To my mind this is what started the financial panic, egged on by the failure to support the preferred stockholders in the Fannie and Freddie nationalizations and the decision to treat AIG so differently from Lehman Brothers.

And the panic got out of control because we have allowed short sellers and rumor-mongers to roil instead of calm the markets on the one hand, and have not had sufficiently flexible circuit breakers to give the markets a bit of a time out on the other.

So where do we go from here?

Short-term relief: The TARP, the liquidity facilities being created by the Federal Reserve, and the nationalization of parts of the financial system will ultimately get the economy under control. The key is for the Fed and the Treasury to act vigorously and liberally with the use of these facilities—to remove the much-discussed stigma of seeking government support. And I still worry that there is a disconnect between policy and bureaucracy, one that can and should be bridged with great haste. However, the cost to the country has been and will be great. And we will have historic choices to make.

It is clear that the deregulatory mantra of the last decade is dead. The real question is how far do we go in terms of regulating the financial system. Do we in essence nationalize it, making banking all but a public utility? I fervently hope not. But we have to massively change how we have been regulating and supervising. We have to take better control of the revolutions in technology and globalization. We have to get the fire back in the fireplace.

A New Framework: In order for America to enjoy the benefits of a modern financial system that can allow it to more readily help to build new factories, hospitals, schools and homes, we need a new regulatory framework, one suited to technology-driven finance of the 21st century. Certain elements of that framework are clear.

1. Sound finance must start with fair treatment of the consumer and much higher standards of market conduct. We cannot allow any American to be knowingly sold inappropriate financial products as has just taken place too often in respect of sub-prime and “alt-A” mortgage products. For all the good we are doing to bolster the financial system, we will have won the battle and lost the war if we fail to redouble our commitment to keeping homeowners in their homes.
2. All financial enterprises should be regulated within a unified framework. In other words, financial enterprises engaged in roughly same activities that provide roughly the same products should be regulated in roughly the same way. The same logic must apply to institutions of roughly the same size—they should be under roughly the same regulatory regime. Just because an institution chooses one charter or one name does not mean it should be able to manipulate the system and find a lower standard of regulation.
3. The U.S. must abandon our alphabet soup of regulators and create a more coherent regulatory service. We have a system that is rooted in a proud history, that includes exceptionally fine and dedicated public servants, and that in many ways has served us well. But it is now beyond debate that a banking framework with its roots in agrarian, 18th century America is in urgent need of a radical, 21st century, global-economy restructuring. However, the secret to effective regulation is not how we move around the boxes. Mashing the alphabet noodles into one incoherent glob will not make the concoction taste any better. What we need is a much more effective regulatory mechanism. We have to take the whole effort up a notch. We have to put the time and energy into determining both what regulations are

effective, and what regulations place pure counterproductive and bureaucratic burdens on institutions.

4. We need to professionalize financial services regulation. We have college degrees for everything from carpentry to desktop publishing to commercial fishing, yet we do not have full courses of studies, degrees, chairs at major universities in supervision and regulation. America is in fact blessed with many talented and dedicated examiners and regulators, but this is in too large a measure despite, not because, of our system of on-the-job training for the guardians of our financial system.
5. We need to deleverage the financial system and country as a whole and restrain excess liquidity build-up. In this regard, we have to encourage savings, eliminate the structural federal budget deficit and contain asset price bubbles before they get so large that pricking them brings down the economy.
6. We must reverse the tendency of the last decade to have pro-cyclical regulatory, accounting and other policies. Mark-to-market accounting is clearly flawed and must be materially re-worked.
7. Finally, we need to align financial rewards for executives with the well-being of their companies and the stakeholders they serve. Clearly, financial institution governance is off kilter when we give a king's ransom to traders and other financial executives who have in essence beggared their companies and then walked away from a shipwreck to a comfortable retirement. At the same time, executives who take the wheel, stay with the vessel, and steer it through stormy seas deserve to be fairly compensated.

These are but a few elements of what must be a greatly changed financial services system. I have also submitted for the record a lecture I was asked to deliver on this topic recently before the International Conference of Banking Supervisors, which provides a more detailed description of my thoughts on how a new financial

services regulatory system would look and function. For America to continue to be a leader in the world and for finance to serve the needs of our people, we cannot wait. We must start now to learn from our mistakes and rebuild.