Testimony of John Reed before the Senate Committee on Banking,
Housing and Urban Affairs
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It is probably too early to fully assess the nature and causes of our recent financial meltdown but the conversation about potential remedies is well underway. Given that fact, a few thoughts could be useful.

First, some “framing”.

One, the crisis was clearly “man made”, this was not the result of long standing and cumulative imbalances.

Second, there seems to have been a key failure that none of us anticipated, namely, individual institutions which are thought to take steps and exercise judgments to insure their self-preservation turned out “not to have” or been incapable of so doing. (This clearly means that in designing a robust system, we cannot count on that capacity.)

Third, a financial system cannot be permitted to impact the real economy to the extent that it has.

Fourth, while much has been made of the low interest rate environment that accompanied the build up to the crisis, one would not design a financial system that could not function in such an environment.

Second, some casual factors that are worth noting.

One, a dominant business philosophy focusing on “shareholder value”.

Two, almost frenetic activity in the creation and distribution of securitized products and derivatives. These turned out to be flawed as credits but further were not fully distributed to “knowledgeable investors” but to an incredible extent were inventoried on the balance sheet of “intermediaries” (e.g., Merrill Lynch, Citi).

Third, the absolute failure of the rating agencies in the performance of their only mission.

Fourth, the failure of supervision,

In allowing the decapitalization of the sector.

In ignoring the implications of “low doc, no doc” lending.

In ignoring the levels of counterparty risk.

In "missing" the fact that credit default swaps were insurance products, requiring reserves and oversight.

Fifth, the failure of policy in pushing the mortgage market through Freddie Mac and Fannie Mae to an uneconomic extent.

Third, if the aim is to create rules and limits, which on the one hand would significantly reduce the likelihood of a repeat of our recent experience, and on the other would support a healthy and creative industry, what would the rules and limits be?

First, capital should be significantly increased, maybe doubled. (I personally think the concept of Risk Adjusted Capital is flawed.)

Second, the funding structure (liquidity) of each institution should be the subject of annual review (not just "point in time", averages and extremes over the year) and assessment by regulators and boards.

Third, the industry should be compartmentalized so as to limit the propagation of failures and also to preserve cultural boundaries.

Fourth, to the extent possible, traded products should flow through Exchanges.

Fifth, there is a good reason to create a Consumer Protection Agency with a clear and separate mandate.