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Oral Testimony  
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Hearing on Systemic Risk and Regulation

Mr. Chairman, Ranking Member Bachus and members of the Committee:

My own career has included many credit cycles which involved issues of systemic risk, from the credit crunch of 1969, the commercial paper panic of 1970, and the real estate investment trust collapse of 1975, to the current subprime mortgage and housing bust, and numerous others in between.

They all put me in mind of the memorable saying of John Maynard Keynes, that a prudent banker is one who goes broke when everybody else goes broke.

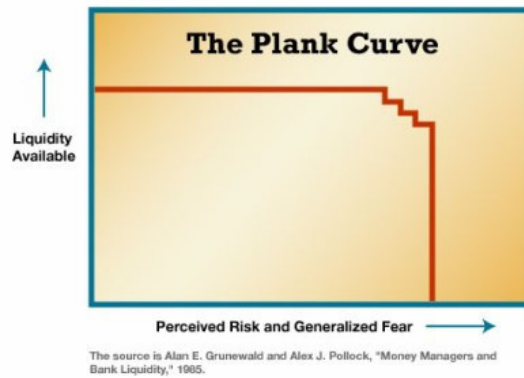
As Keynes suggests, “prudence” means doing what everybody else is doing, a key component in financial booms and busts.

To put these in context, maximum long term growth and the greatest economic well being for ordinary people depends on market innovation and experimentation. But these of course make the future more uncertain. Markets for financial instruments by definition place a current price on future, thus inherently uncertain, events.

This much is obvious, but easy to forget when addressing the results of a bust with the benefit of hindsight, when it seems like you would have had to be stupid to make the mistakes that smart people actually did make.

In the boom, many people succeed, just as many people succeeded in the long housing boom. This success gets extrapolated and makes lenders and investors confident. Investor confidence tends to the underestimation of future uncertainties, notably in a leveraged sector, where there comes to be a lot of investing long and borrowing short.

Risky, illiquid assets get to be financed by very risk-averse, short term lenders, such as commercial paper buyers and repo dealers. They are likely to behave like the depositors of Britain's Northern Rock—that is to say, in the manner of the Plank Curve.



This is the Plank Curve, which describes the short term credit available in a panic—the name comes from its path being the same as a man walking the plank.

We know for certain that markets will create both long term economic growth and also cyclical booms and busts.

Markets are recursive. Models of financial behavior may themselves change the market, and therefore become less effective or obsolete, as did the subprime credit models of both investors and the rating agencies.

One way to go broke when everybody else does, is to use models with the same assumptions that everybody else has. This should make us skeptical of the model-based regulatory approach of Basel II.

Charles Kindleberger, surveying several centuries of financial history, observed that financial crises and scandals occur, on average, about once every ten years—regardless of what legislatures or regulators do.

Every bust is followed hopes that the reforms have solved the problem. For example, in 1914, the then-Comptroller of the Currency announced that with the creation of the new Federal Reserve, "financial and commercial crises or panics...seem to be mathematically impossible."

Of course, in time the next bust arrives, nonetheless.

Although this should make us wary of excessive claims about what regulation can do, it doesn't mean we should not have reforms.

Greater disclosure certainly makes sense. The subprime mortgage bust suffered from inadequate disclosures all the way from the consumer to the ultimate investor levels.

The role of credit rating agencies is part of this issue. I think we should be working on ways to make investor-paid rating agencies a greater force in this key information-providing sector.

A disclosure reform particularly pertinent to private pools of capital would be to require symmetrical disclosure of short and long equity concentrations. Concentrated short positions in a company's stock should be reported in exactly the same way as long positions.

And it would certainly be a good idea to make whatever deal with the Senate is necessary to enact regulatory reform for the housing GSEs.

As Walter Bagehot wrote, "Every great crisis reveals the excessive speculations of many houses which no one before suspected." The current bust is true to type and we'll continue to see large losses revealed.

As everybody gets used to the idea that these losses have happened, I think liquidity will return reasonably quickly to markets for prime instruments. One insightful observer has predicted that "the panic about credit markets will be a memory by Thanksgiving."

For prime markets, I believe he is right; however, the severe problems with subprime mortgages and securities made out of them, related defaults and foreclosures, and most importantly, falling house prices, will continue long past then. The "interesting times" in the wake of the bursting of the subprime and housing bubble has a good way yet to run.

Thank you again for the opportunity to share these views.