Testimony of Dr. Alan Greenspan
Committee of Government Oversight and Reform
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Mr. Chairman and Members of the Committee:

Thank you for this opportunity to testify before you this morning.

We are in the midst of a once-in-a century credit tsunami. Central banks and governments are being required to take unprecedented measures. You, importantly, represent those on whose behalf economic policy is made, those who are feeling the brunt of the crisis in their workplaces and homes. I hope to address their concerns today.

This morning, I would like to provide my views on the sources of the crisis, what policies can best address the financial crisis going forward, and how I expect the economy to perform in the near and longer term. I also want discuss how my thinking has evolved and what I have learned in this past year.

In 2005, I raised concerns that the protracted period of underpricing of risk, if history was any guide, would have dire consequences. This crisis, however, has turned out to be much broader than anything I could have imagined. It has morphed from one gripped by liquidity restraints to one in which fears of insolvency are now paramount. Given the financial damage to date, I cannot see how we can avoid a significant rise in layoffs and unemployment. Fearful American households are attempting to adjust, as best they can, to a rapid contraction in credit availability, threats to retirement funds, and increased job insecurity. All of this implies a marked retrenchment of consumer spending as households try to divert an increasing part of their incomes to replenish depleted assets, not only in 401Ks, but in the value of their homes as well. Indeed, a necessary condition for this crisis to end is a stabilization of home prices in the U.S. They will stabilize and clarify the level of equity in U.S. homes, the ultimate collateral support for the value of much of the world's mortgage-backed securities. At a minimum, stabilization of home prices is still many months in the future. But when it arrives, the market freeze should begin to measurably thaw and frightened investors will take tentative steps towards reengagement with risk. Broken market ties among banks, pension, and hedge funds and all types of nonfinancial businesses will become reestablished and our complex global economy will move forward. Between then and now, however, to avoid severe retrenchment, banks and other financial intermediaries will need the support that only the substitution of sovereign credit for private credit can bestow. The $700 billion Troubled Assets Relief Program is adequate to serve that need. Indeed the impact is already being felt. Yield spreads are narrowing.

As I wrote last March: those of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief. Such counterparty surveillance is a central pillar of our financial markets' state of balance. If it fails, as occurred this year, market stability is undermined.

What went wrong with global economic policies that had worked so effectively for nearly four decades? The breakdown has been most apparent in the securitization of home mortgages. The evidence strongly suggests that without the excess demand from securitizers, subprime mortgage originations (undeniably the original source of crisis) would have been far smaller and defaults accordingly far fewer. But subprime mortgages pooled and sold as securities became subject to explosive demand from investors around the world. These mortgage backed securities being "subprime" were originally offered at what appeared to be exceptionally high risk-adjusted market interest rates. But with U.S. home prices still rising, delinquency and foreclosure rates were deceptively modest. Losses were minimal. To the most sophisticated investors in the world, they were wrongly viewed as a "steal."

The consequent surge in global demand for U.S. subprime securities by banks, hedge, and pension funds supported by unrealistically positive rating designations by credit agencies was, in my judgment, the core of the problem. Demand became so aggressive that too many securitizers and lenders believed they were able to create and sell mortgage backed securities so quickly that they never put their shareholders' capital at risk and hence did not have the incentive to evaluate the credit quality of what they were selling. Pressures on lenders to supply more "paper" collapsed subprime underwriting standards from 2005 forward. Uncritical acceptance of credit ratings by purchasers of these toxic assets has led to huge losses.

It was the failure to properly price such risky assets that precipitated the crisis. In recent decades, a vast risk management and pricing system has evolved, combining the best insights of mathematicians and finance experts supported by major advances in computer and communications technology. A Nobel Prize was awarded for the discovery of the pricing model that underpins much of the advance in derivates markets. This modern risk management paradigm held sway for decades. The whole intellectual edifice, however, collapsed in the summer of last year because the data inputted into the risk management models generally covered only the past two decades, a period of euphoria. Had instead the models been fitted more appropriately to historic periods of stress, capital requirements would have been much higher and the financial world would be in far better shape today, in my judgment.

When in August 2007 markets eventually trashed the credit agencies' rosy ratings, a blanket of uncertainty descended on the investment community. Doubt was indiscriminately cast on the pricing of securities that had *any* taint of subprime backing. As much as I would prefer it otherwise, in this financial environment I see no choice but to require that all securitizers retain a meaningful part of the securities they issue. This will offset in part market deficiencies stemming from the failures of counterparty surveillance.

There are additional regulatory changes that this breakdown of the central pillar of competitive markets requires in order to return to stability, particularly in the areas of fraud, settlement, and securitization. It is important to remember, however, that whatever regulatory changes are made, they will pale in comparison to the change already evident in today's markets. Those markets for an indefinite future will be far *more* restrained than would any currently contemplated new regulatory regime.

The financial landscape that will greet the end of the crisis will be far different from the one that entered it little more than a year ago. Investors, chastened, will be exceptionally cautious. Structured investment vehicles, Alt-A mortgages, and a myriad of other exotic financial instruments are not now, and are unlikely to ever find willing investors. Regrettably, also on that list are subprime mortgages, the market for which has virtually disappeared. Home and small business ownership are vital commitments to a community. We should seek ways to reestablish a more sustainable subprime mortgage market.

This crisis will pass, and America will reemerge with a far sounder financial system.