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*Remarks by Barney Frank**

Thank you. Thank you. I'll talk for a while, but I want to leave maximum time for conversation, because frankly I learn from the questions and comments people make what the areas of interest are. And when we get to that discussion period—excuse me—and I appreciate . . . for some reason moderators instruct people in the audiences that they are to ask a question, and not make a comment. I have never understood why people like myself are supposed to be comment phobic and have to be protected from people's opinions. So if you want to make a comment and want me to respond, that would be fine.

I'll set out briefly with what we thought we were doing. I will give you a little background. I got on the committee, and I later became chairman because of my interest in affordable housing. It was then called the committee on Banking, Financing, and Urban Affairs. In fact, at the time I got on it, illogically, but for historical reasons, jurisdiction over the banking industry was separate from jurisdiction over the securities industry. And it wasn't until 2003 that they were merged. And they were merged, by the way, by the Republicans in control of the house—not because of some final recognition of the inherent logic of dealing with these two related subjects in one place, but because they had two equal contestants for particular committee chairmanship, and the only way to resolve it was involving this. I say that because before 2003 when I became the senior Democrat on the committee and the committees' jurisdiction merged I never paid much attention to the securities side. I did have to learn it.

I say that because, if we get into it, the question is what were you doing when the trouble was starting. I will claim to have been active in trying to stop the proliferation of subprime mortgages because that was under the jurisdiction of the committee I was on. I can't claim any credit for having been concerned about the problems with derivatives, nor any blame. I just wasn't involved. But as I became chairman and my attention

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got focused on the financial crisis and people ask when, well, starting really in 2006 when Henry Paulson was named Secretary of Treasury under Bush, and it became clear to people that the Democrats were going to win the house in 2006 and I was going to be the chairman, and he began telling me of his concerns and of their feelings, his and Ben Bernanke, Chairman of Fed, that they did not have the tools to deal with this; so I did began to look into it.

By 2008, early on, when the Bush administration had to make JP Morgan Chase take over Bear Stearns, it was clear trouble was coming. And as it went on I really developed a theory about what was happening and what we were doing, and I think it was—the economic history of America, and other capitalistic societies I assume, is pretty straight forward. The private sector innovates. Government role is to have regulations that try to promote the good things that the private sector does and retard the bad things. Over time, the innovations in the private sector outstrip the regulation. So, then the question is, *can you update the regulation?* The stock market metastasizes in the twenties and all kinds of things go on and it isn't until the thirties that the regulation catches up. But by the end of the New Deal, there was a pretty good system of regulation of banks and securities firms done by the New Deal that lasted pretty well until the eighties. And then beginning in 1980 two innovations had the private financial system outstrip the regulation.

The first was that a lot of money started coming into our economy available for loans from outside the banking system. The banking system had been pretty tightly regulated, so if you were borrowing money from a bank, there were pretty strict rules. And most of the borrowing that took place, took place from banks. And if you borrowed from a bank, you were borrowing from the entity which expected you, not expected you to, which you had an obligation to repay. And since the bank's income depended on your repaying, they frisked you pretty good before they lent you the money. If they lent money to people who aren't going to repay them, they got hurt.

Now a flood of money comes in from oil producing countries. Remember OPEC starts around that time; from sovereign wealth funds; from countries that have these enormous increases in their trade balances. And as a result, beginning in the eighties, money is available for lending outside the banking system. That erodes even the rules in the banking system because the banks are now under competitive pressures. But the second thing that had to happen to create the crisis was information technology, because the distinctive factor of that economy was that the loan business shifted.

Instead of making loans to people who were going to pay you back, and you then worry about whether or not they had the capacity to pay you back, by the nineties loans were being made by institutions that promptly packaged the loans and sold the right to be repaid in securities—securitization. Well, if I am going to be repaid by the borrowers, I am careful about the borrowers. If I get to sell the loan to somebody else and get my money up front, and I don't have to worry about whether the borrowers repay, my incentive shifts from worrying about the quality of each loan to the quantity of loans. And what happens is that loans are made without regards to the ability to repay, and they are then packaged into securities. And that leads to development of financial derivatives. Derivatives have been around for a while. They were pork bellies and oil. Derivatives were a way that people whose livelihood depended on the price of a commodity could protect themselves against wild price swings, but now that was being applied to financial instruments, and given great leverage. So those two things transformed the nature of the lending business.

By the nineties, you had this wonderful system for a lot of financial institutions whereby they had found a way to make money by doing things that were risky in principle, but not in a way that implicated them. If you are a bank, and you can loan money to thousands of people, and then securitize those loans, and sell the right to be repaid, you have created a risk of nonrepayment, but you are not the bearer of the risk. That risk is then dissipated out into the economy.

The theory was that people, the gate keepers of risk—it sounds just ridiculous now to saying it, but people believed it at the time, the gate keepers—the new gate keepers to keep bad risk out were going to be the rating agencies. Michael Lewis's *The Big Short* did a wonderful job there. You had the rating agencies that would look at these packages of loans and tell people whether or not there was a high likelihood of them being repaid. It should be very clear that they were violating an important principle that ought to govern commerce, and you'll forgive the directness, but it is the only way to get the point across: *You should not make shit up*. But they did. They literally just made it up. They had no idea—no idea. They didn't do any research. They didn't do any sampling. They just guessed how much those packages would be worth.

Of course, they were rating the packages for the people who were going to sell the packages who paid them for the rating. One of the things we were not able to do: Anticipate the big question. That model is still there for this reason. It's impossible to come up with a buy-side rating scheme. If you have ratings that are disseminated for the buyers, nobody has the incentive to pay for that rating. If I am selling you a security, I have an incentive to pay to have my security rated. But if I pay to have it rated, you are going to have that conflict. The one good thing we were able to do that I was proud of, was to simply repeal any rules at the federal level that required anybody to rely on the rating agencies before they bought something. But it still hasn't done as much. But anyway, that's where we were.

The financial system had outrun the regulations, so there were no regulations about loans being made. There were no regulations under derivatives. Specifically, with the derivatives, people were able to engage in derivative transactions with no need to show that they could pay off: You know, if you buy a stock you have to post some minimum amount. If you are selling a derivative, you were able to sell that derivative. *Credit Default Swap*, which is this wonderful name which they came up with, and *Credit Default Swap* is insurance. Now we have a principle in America with insurance that if you try to sell insurance, life, death, casualty, fire, you have to show some regulator that you have the money to pay off. But it turns out that if you call it a credit default swap, you're not subject to any state's insurance rules, and you can insure the mortgages people, the packages of mortgage people have bought, even if you don't have any money.

And so what happened was that. People who'd gotten mortgages and could not pay them off, defaulted. As they defaulted the securities that were based on their repayment string also defaulted. When they defaulted, the holders of the securities went to the issuers of these credit default credit swaps and said, "You got to pay up." And the issuers of the credit default swap said, "Who me?" They didn't have any money. If you think there is an exaggeration here, one of the biggest issuers, one of the most important respected financial institutions in America, was the AIG American International Group, and they were a major seller of credit default swaps. They made a lot of money selling regular insurance; they made so much money selling regular insurance they literally didn't know what to do with it. So, they started selling credit default swaps. They not only sold many more credit default swaps than they could pay off when the underlining securities began to fail, they had literally no idea how much they owed. Again, I know it sounds like I am making stuff up myself.

Two days after Lehman Brothers failed, AIG went into the Federal Reserve and told Chairman Bernanke that they were $85 billion dollars in debt beyond what they could pay for these failed securities. A week later, in a meeting that he was having with Congressional leaders, Bernanke was counting up—he and Paulson—how much money they were going to need to pay, to stabilize things. And he said, "Oh, and $85 billion for AIG." We said, "You know, we are paying attention when you told us that last week, the $85 billion for AIG." He sounded a little offended and said, "Oh, I apologize, that's an additional $85 billion for AIG."

AIG not only couldn't pay off its credit default swaps—this great respected financial institution—they had first thought they were $85 billion in debt and they turned out ultimately $175 billion in debt. They didn't even get it quite right the second time. By the way, after the federal government paid off that—and AIG ultimately paid it back, but it kept them alive—the AIG founder, who was no longer running the company, but he was the major shareholder, he sued the federal government. He sued Bernanke and Paulson on the grounds that when the federal government paid off the $170 billion in debt that he couldn't handle, the company was treated unfairly. My characterization of that, it was the arsonist suing the fire department for water damage. The Court of Claims, which are notoriously friendly to claimants, but they found that technically he had an argument because they had not followed the rules, and they awarded him $1.00 in damages.

But anyway, that's where we come in. We have a situation in which the business of lending has been transformed into one in which people make loans, get paid by the quantity of the loans they make, and then other people take those loans and package them and make money selling them back and forth and insuring them. And the house of cards collapses when at the root the loans can't be paid off. My metaphor here is that the loans were the bullets, the bad loans, and the derivatives were the guns that spread them throughout the system. So that's what we figured out, that what we had to do was to come up with new rules to regulate these things. So what we did was we acted on several levels.

First, most importantly, we outlawed the worst of the loans. We said you just can't make some of these loans period. We also, and here the regulators didn't do everything I wanted, we pushed for a requirement that we call risk retention, some people call it skin in the game—namely, that if you sell something, if you make a loan and then you sell it, you have to retain some percentage of the loss: give you some incentive not to do it. Now that remains in effect, a requirement for risk retention for many packages, paradoxically, not for mortgage loans. But mortgage loans are still restricted statutorily; there are categories you cannot offer.

Then we went to derivatives and basically passed the law that said you can no longer engage in a derivative transaction without demonstrably having the money to pay off, if a reasonably foreseen percentage don't pay. And we did that in several ways. The most important was to require that derivatives be traded on exchanges the way stocks are. They had argued that the derivatives were all one-off: They all had to be individual because they were individually tailored. That turned out to be greatly exaggerated. We did allow for that, but at an increasing percentage, most derivatives are now traded on exchanges. And when it goes on an exchange, the exchanges have to make sure both sides have the money.

So, when you sell a stock on the exchange, you don't have to worry that the person who bought your stock is then going to say, "Oh, I'm sorry, but I can't pay for that." They can no longer do that; the exchange makes sure that the money is there. For derivatives sold off exchanges, there is a requirement that they have margin: that they publish how much they are going to do, and they show that they can pay it off.

Those two were aimed at reducing the extent to which financial institutions would incur indebtedness. Remember, the problem was financial institutions incurring indebtedness beyond what they could pay. And that's why, to anticipate, I never thought the problem was the size of the financial institution. The problem is the size of the indebtedness that the institution has that it cannot repay. What we did first of all, as I said, was to make it less likely that you would have these unrepayable debts by banning the bad mortgages and requiring that there be money behind derivatives. The next level of defense was to say, look those are not always going to work; there are still going to be some bad trades; there are still going be some problems. So the next requirement was that any institutions that engaged in this kind of financial activity had to have a much bigger stock of capital to pay off. That's one of the biggest things that is done for banks and for others. If you are in the business of taking financial risk, you are now required to have a much higher level of capital, so that if a certain percentage of what you do fails, you are still there. That's the second level of defense.

The third level of defense is what's called orderly liquidation. Paulson and Bernanke, this one may be the most controversial—including some of my friends on the left, who I think just get it wrong—Paulson and Bernanke in 2008, when they had to deal with Bear Stearns, told us, "Here's the problem we have." If a large financial institution can't pay its debts—and by the way, the fear of why we worry about a large institution not paying it debts, not because we want to be nice to them, but because things are interconnected. If a very large institution can't pay its debts, then its debtors cannot pay their debts, and the debtors' debtors can't pay their debts, and it spirals downward: there is a contagion. So what you try to do is pay some of the debts so it does not go beyond that.

What Paulson and Bernanke told us in 2008 was that they had two choices if a large financial institution couldn't pay its debts: Lehman and AIG were within two days of each other, were the example. When Lehman came to them and said, "We can't pay our debts," they say, there's controversy about, we can get into it, Paulson and Bernanke said, "Well, that's too bad, we can't do anything about it." Their view was that the federal government could intervene as it did with Bear Sterns or as it did with AIG only if the entity seeking help was temporarily unable to pay its debts but could be seen as regaining its solvency if it got help.

They couldn't give to people who had no chance of recovery; they believed that Lehman had no chance of recovery.

They tried to get the British bank, Barclays, to buy Lehman, and the British authorities said you have to contribute some, and they said, "No we can't, we couldn't give any federal money." And the British said, "Let me see if we understand this: you have this failing American institution, and you would like the British government to bail it out; we don't think so." And Paulson had to say, "Ya, I guess you have a point." So Lehman failed. The failure of Lehman traumatizes people. It turns out when Lehman fails, that everybody gets worried.

Nobody is going to lend money to anybody else, because this whole system of being able to count on the money isn't there. There were some people, particularly Republicans, who welcomed Lehman failing. These were people who were very critical when Bear Stearns was saved, because the debtors of Bear Stearns were saved, Bear Sterns as an entity disappeared and became part of JP Morgan Chase. And there was some celebration, some conservative Republicans said, "Wonderful, now we have free enterprise, we let them fail." By Tuesday, they failed on Sunday morning, or Sunday night, by Tuesday the consequences on that failure were traumatizing people. The economies everywhere were shutting down.

By the way, people have talked about the crash of 2008 being worse, almost as bad as the Great Depression. In some ways it was worse because, during the Great Depression, you still had geographic granularity. Something could be terrible in one part of the world and not so bad elsewhere. By 2008 the entire financial world was on one grid. So when there was a problem anywhere, there was a problem everywhere. And so, as a result of that Paulson and Bernanke decided, and with a lot of support, "We can't let another institution of this size simply go out of business."

I was interested myself to note that a number of the conservative purists who had celebrated the advent of free enterprise with the collapse of Lehman became a little less enamored with pure free enterprise. In fact, I announced that I was filing a bill to make September fifteenth, the day Lehman failed, Free Enterprise Day to commemorate the one day in American history when we had had free enterprise. But by Wednesday, when AIG came in and Paulson and Bernanke said, "Ok we are going to pay your debts," here was the problem: They had been telling us all year that they had two choices, they could either pay none of the debts (Lehaman), or all of the debts (AIG), and neither one was satisfactory.

And what they wanted was an ability for the Federal Government to step in. In that case, pay, put the institution out of business, but in an orderly fashion—that's why it is called the Orderly Liquidation

Authority—and to have them pay some of the debts, but not all. Under existing law, you had to pay everybody or nobody; we gave them the authority to pay some of the debts, not all. And, it is important, there is a mandate that, if the Federal Government has to step in in a situation like that and put up some money to pay some of the debts after the entity has completely liquidated, the Secretary of Treasury then has to recover any amount paid out for those debts from financial institutions worth $50 billion or more. And that's a mandate.

Now you will have some people say, "Oh, we haven't solved the problem." So, that's, that's the answer regarding too big to fail. First of all, we make it much less likely that institutions will fail by not letting them engage in risky transactions. And at the second level of defense, requiring them to have more money in case they do engage in risky transactions and have to pay up. But the third level is, if both of those fail, they've taken too many risks and have too little money despite our best efforts to pay it off, they fail; they are put out of business. They are too big to fail without some intervention, but they fail and the Federal Government steps in and pays only some of their debts.

What you have are some critics of our third approach. They're saying, "Oh, it will never work because if a very large financial institution can't pay its debts and it is threatened with being put out of business, there will be enormous political pressure on the president to step in and save it." And, I do not know where those people have been living, but it cannot have been in America for the past ten years. Because if a large financial institution these days—and still, for the anger has not gone away—were to be in serious financial difficulty, and come to the federal government and say, "We now have much more debt than we can pay off, you got to help us," there would be overwhelming public demand that we shoot them. The notion that they would be candidates for bailouts is ridiculous. At any rate, that's what we did.

We think, I was saying to Doug the other day, that's been working pretty well. One indication of that, *Wall Street Journal* first page this morning, *Goldman Sachs Has Transformed Its Business Model*. Goldman Sachs is doing much less trading—much less of the razzle dazzle, wheeler dealer stuff—and much more conventional banking—doing investment banking. They are helping companies raise money. They are lending. There has been a significant move in the financial industry towards less glamourous and more stable activity.

We had our friends on the left who said, "Oh, you didn't do enough," and they were hypercritical of everything we did. Amongst the things we did, of course, was the Consumer Financial Protection Bureau, Elizabeth Warren's idea. But many of the people on the left said, "No you didn't do enough, that's not going to work." They continued to argue that what we did wasn't worth anything until Donald Trump got elected and announced that he was going to dismantle it—after which it suddenly became much too important to let him dismantle. They're in fact right. The law has worked substantially as we wanted it to. There are very few derivatives these days of the kind AIG engaged in where the counterparties, as they are called, don't have enough money between them. Derivatives these days are much more carefully monitored, and they are exchanged under derivatives. The bad loans are not being made anymore.

Now, a bill did go through to modify this. I thought it made one mistake: It raised the level at which a bank gets extra supervision from the federal regulators from $50 billion in assets to $250. I thought $125 was appropriate. I thought for some years that that should have been it, and I regret that. But, that is a fairly small change. The main thing the bill did that was signed into law was to take away the grievances of the smallest banks under $10 billion. They did not really contribute that much to the crisis, but they are the ones with the political clout. Frankly, Bank of America and JP Morgan Chase don't have a lot of political influence. They only have a presence in a few districts, and nobody likes them. One of the districts is mine. The CEO of Bank of America was my constituent, but he understood we were going to do what we did. The smaller banks, on the other hand, they are in everybody's district. The community bank is at the Rotary, and they are everywhere. So they are the ones with political clout. So what Congress did was to buy off the only element in the political atmosphere that had the clout to force changes in the bill. So, the bill will now stay exactly as it is indefinitely, and it is very much in effect.

On the other hand, we have Trump and a few of the other right wingers arguing that we had so over regulated the financial system that we had greatly hindered its ability to perform its function. Remember, the function of the financial system is technically intermediation. The notion is that the financial system scoops up money from people who have surplus money and nothing particularly productive to do with it, but are looking for a return on that money. So they make it available through the financial industry to the productive elements in society so that people who make things and employ people, they, the banks are the intermediaries between other individuals with extra cash and the productive sector. And the argument is that we basically hindered the ability of the financial institutions to do this. And if the productive sector of the economy is prevented from getting the money that people are looking to make available, then the economy is obviously going to suffer.

The problem for President Trump is that he makes that argument while simultaneously noting that we have an economy that God wishes he could have. It really is not logically possible to insist that we have the best economy in the history of the world, humming along at full productive weight, but that somehow the liberals crippled the mechanism by which it functions. The fact is, what we did has had very little negative effect on the economy, has increased stability. And that's why *de facto* we are at a situation now where this is going to go forward.

The final I'd say is, while Trump says one thing, his actions haven't always correlated. Many of Trump's appointees to the important positions in fact have implicitly, and in some cases, explicitly, accepted it. Jay Powell, the new Chairman of the Federal Reserve, is fully in accord with the legislation and in using those powers. In fact, where the Congress lowered the level down to $250 where you do extra supervision, Powell has said that he will use the powers the Fed still has to supervise people below that anyway. So, it's not automatic, but he can do it as a matter of discretion. The head of the Commodity Futures Trading Commission—which is the major entity for regulating derivatives—Christopher Giancarlo, says he likes the bill and he is enforcing it.

So, summary and I will throw this open. We believe what we did was to correct the problem of innovations outstripping regulations which allowed financial institutions to load risk into the economy as a whole and profit from doing that without themselves being exposed to the risk so that they had an incentive to do that. We, I think, have corrected that. We have reconnected the ability to incur risk for the economy with the liability for that risk to the institution involved in a way that it has not in any shape or form slowed down the economy.

Last point as part of that: We did make some effective changes in the compensation system. It is true that the CEOs of these entities and others still make very large sums of money, but that was less the issue than the way the incentive system worked. The way the incentive system worked, they had a bonus system which essentially was head you win, tails you break even. People could take risks: If the risk paid off, they got money; but if the risk failed, they didn't lose anything. So, we have done two things in the bill. One, we have given the shareholders the right to vote every few years, on whether they like the share of the CEO's pay or not, and a couple have voted it down. But more importantly, there was a requirement that any bonus, any incentive system be two-way. That to the extent that people make money if something they do goes up, then they lose money if it goes down, called clawbacks. And that, we believe, has also had an effect on tamping down the taking of risk. But the main thing to do was to institutionally reconnect the legal authority to incur risk with the liability for paying off the risk if it didn't work out as you thought; and we think it has worked out well.