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Greenspan Concedes Error on Regulation

By EDMUND L. ANDREWS

WASHINGTON — For years, a Congressional hearing with Alan Greenspan was a marquee event. Lawmakers doted on him as an economic sage. Markets jumped up or down depending on what he said. Politicians in both parties wanted the maestro on their side.

But on Thursday, almost three years after stepping down as chairman of the Federal Reserve, a humbled Mr. Greenspan admitted that he had put too much faith in the self-correcting power of free markets and had failed to anticipate the self-destructive power of wanton mortgage lending.

"Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief," he told the House Committee on Oversight and Government Reform.

Now 82, Mr. Greenspan came in for one of the harshest grillings of his life, as Democratic lawmakers asked him time and again whether he had been wrong, why he had been wrong and whether he was sorry.

Critics, including many economists, now blame the former Fed chairman for the financial crisis that is tipping the economy into a potentially deep recession. Mr. Greenspan's critics say that he encouraged the bubble in housing prices by keeping interest rates too low for too long and that he failed to rein in the explosive growth of risky and often fraudulent mortgage lending.

"You had the authority to prevent irresponsible lending practices that led to the subprime mortgage crisis. You were advised to do so by many others," said Representative Henry A. Waxman of California, chairman of the committee. "Do you feel that your ideology pushed you to make decisions that you wish you had not made?"

Mr. Greenspan conceded: "Yes, I've found a flaw. I don't know how significant or permanent it is. But I've been very distressed by that fact."

On a day that brought more bad news about rising home foreclosures and slumping employment, Mr. Greenspan refused to accept blame for the crisis but acknowledged that his belief in deregulation had been shaken.

He noted that the immense and largely unregulated business of spreading financial risk widely, through the use of exotic financial instruments called derivatives, had gotten out of control and had added to the havoc of today's crisis. As far back as 1994, Mr. Greenspan staunchly and successfully opposed tougher regulation on derivatives.

But on Thursday, he agreed that the multitrillion-dollar market for credit default swaps, instruments originally created to insure bond investors against the risk of default, needed to be restrained.

“This modern risk-management paradigm held sway for decades,” he said. “The whole intellectual edifice, however, collapsed in the summer of last year.”

Mr. Waxman noted that the Fed chairman had been one of the nation’s leading voices for deregulation, displaying past statements in which Mr. Greenspan had argued that government regulators were no better than markets at imposing discipline.

“Were you wrong?” Mr. Waxman asked.

“Partially,” the former Fed chairman reluctantly answered, before trying to parse his concession as thinly as possible.

Mr. Greenspan, celebrated as the “Maestro” in a book about him by Bob Woodward, presided over the Fed for 18 years before he stepped down in January 2006. He steered the economy through one of the longest booms in history, while also presiding over a period of declining inflation.

But as the Fed slashed interest rates to nearly record lows from 2001 until mid-2004, housing prices climbed far faster than inflation or household income year after year. By 2004, a growing number of economists were warning that a speculative bubble in home prices and home construction was under way, which posed the risk of a housing bust.

Mr. Greenspan brushed aside worries about a potential bubble, arguing that housing prices had never endured a nationwide decline and that a bust was highly unlikely.

Mr. Greenspan, along with most other banking regulators in Washington, also resisted calls for tighter regulation of subprime mortgages and other high-risk exotic mortgages that allowed people to borrow far more than they could afford.

The Federal Reserve had broad authority to prohibit deceptive lending practices under a 1994 law called the Home Owner Equity Protection Act . But it took little action during the long housing boom, and fewer than 1 percent of all mortgages were subjected to restrictions under that law.

This year, the Fed greatly tightened its restrictions. But by that time, the subprime market as well as the market for other kinds of exotic mortgages had already been wiped out.

Mr. Greenspan said that he had publicly warned about the “underpricing of risk” in 2005 but that he had never expected the crisis that began to sweep the entire financial system in 2007.

“This crisis,” he told lawmakers, “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.”

Many Republican lawmakers on the oversight committee tried to blame the mortgage meltdown on the unchecked growth of Fannie Mae and Freddie Mac, the giant government-sponsored mortgage-finance companies that were placed in a government conservatorship last month. Republicans have argued that Democratic lawmakers blocked measures to reform the companies.

But Mr. Greenspan, who was first appointed by President Ronald Reagan, placed far more blame on the Wall Street companies that bundled subprime mortgages into pools and sold them as mortgage-backed securities. Global demand for the securities was so high, he said, that Wall Street companies pressured lenders to lower their standards and produce more “paper.”

“The evidence strongly suggests that without the excess demand from securitizers, subprime mortgage originations (undeniably the original source of the crisis) would have been far smaller and defaults accordingly far lower,” he said.

Despite his chagrin over the mortgage mess, the former Fed chairman proposed only one specific regulation: that companies selling mortgage-backed securities be required to hold a significant number themselves.

“Whatever regulatory changes are made, they will pale in comparison to the change already evident in today’s markets,” he said. “Those markets for an indefinite future will be far more restrained than would any currently contemplated new regulatory regime.”