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Bernanke Says He Failed to See Financial Flaws

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WASHINGTON — Ben S. Bernanke, who told Congress in 2007 that the subprime mortgage crisis was “likely to be contained,” said Thursday that he had failed to recognize flaws in the financial system that amplified the housing downturn and led to an economic disaster.

Under pointed but polite questioning from members of the Financial Crisis Inquiry Commission, Mr. Bernanke, the chairman of the Federal Reserve, signaled that the central bank was eager to embrace its expanded powers under the Dodd-Frank financial regulatory law that President Obama signed in July.

Mr. Bernanke spoke favorably of forcing huge banks to hold much more capital, particularly if they were systemically important — so much capital that being big would be costly. He declared that “for capitalism to work,” executive pay had to be linked to performance. And he said Americans were justifiably angry that bankers “who drove their companies into a ditch walked off with lots of money.”

He reiterated that the Fed could not have prevented Lehman Brothers from declaring bankruptcy on Sept. 15, 2008, the financial crisis’s nadir moment. But he said he might have unwittingly “supported this myth that we did have a way of saving Lehman,” by failing to make it clear to Congress at a hearing shortly after the bankruptcy that the Fed did not have other options.

“This is my own fault, in a sense,” Mr. Bernanke said, adding that he was worried at the time about contributing to panic in the markets. “I regret not being more straightforward there.”

Mr. Bernanke said that when he made his remarks in 2007 he thought the subprime problems were “manageable.”

“What I did not recognize was the extent to which the system had flaws and weaknesses in it that were going to amplify the initial shock from subprime and make it into a much bigger crisis,” he said.

While Mr. Bernanke stuck with his long-held stance that the Fed had not aided the housing bubble by keeping interest rates too low for too long in 2002-4, he embraced the view of Gary B. Gorton, an influential Yale finance professor.

Professor Gorton has compared the crisis to a classic bank run, but with the “banks” in this case being short-term wholesale financing markets — a loosely regulated, uninsured system known as shadow banking.

Mr. Bernanke offered an analogy of his own, likening the housing crisis to E. coli bacteria that can have deadly consequences when passed along through a vulnerable food safety system.

“E. coli got into the food system, and it created a much bigger problem,” he said. “There was an awful lot of dependence on short-term, unstable funding, which is analogous to the deposits in banks before the period of deposit insurance.”

Asked about the role of financial innovation in the economy, Mr. Bernanke, said that “innovation is not always a good thing.” Some innovations have unpredictable consequences, are used primarily “to take unfair advantage rather than to create a more efficient market,” and create systemic risks, he said.

In a 2002 speech when he was a Fed governor, Mr. Bernanke argued that central banks should not try to use monetary policy to pop asset bubbles. As part of his nearly three hours of testimony on Thursday, Mr. Bernanke held to that view, but said that at the time he had called for careful supervision and regulation to maintain financial stability.

“We didn’t do that,” conceded Mr. Bernanke, who became Fed chairman in 2006. “Going forward, we need to be able to do that.”

As he did in an address to the American Economic Association in January, Mr. Bernanke argued against the perspective that the Fed stood by passively, “not recognizing the obvious,” as housing prices soared.

“As of 2003 to 2004, there really was quite a bit of disagreement among economists about whether there was a bubble, how big it was, whether it was just a local or a national bubble,” Mr. Bernanke testified.

He added: “By the time it was evident that it was a bubble and that it was going to create risk to the financial system, it was rather late to address it through monetary policy.”

Mr. Bernanke said the most important lesson of the crisis was the need to end the “too-big-to-fail problem,” a view echoed by Sheila C. Bair, the chairwoman of the Federal Deposit Insurance Corporation, who also testified Thursday.

The Dodd-Frank legislation gives the Fed oversight over the largest financial institutions, including those that are not banks. It gave the Fed a prominent role in the Financial Stability Oversight Council, a body of regulators with the power to seize and break up a systemically important company if it threatens economic stability. The F.D.I.C. would manage that process, known as resolution.

In deciding which large companies will fall under its supervision, Mr. Bernanke said, the Fed will look at size, complexity, interconnectedness and degree of involvement in areas like payments and settlements systems.

He also said the Fed was overhauling how it supervises banks. Alongside traditional examiners, the Fed has assigned additional finance experts, accountants, economists and lawyers to work on oversight. “We really need to take a much broader, multidisciplinary approach,” he said.

Mr. Bernanke and Ms. Bair said it was also imperative that the Basel Committee on Banking Supervision, an international coordinating body of regulators, impose tougher standards on how much and what kinds of capital banks must hold.

The increased capital requirements should include capital that is more aligned with risk and able to absorb losses more effectively, and that works in a countercyclical manner, so that banks have more of it during times of financial stress, he said.

Several European countries have expressed resistance to the Basel process, seeking either to weaken some of the requirements or to stretch out the period of time before the new rules will take effect.