

Policy Responses to the U.S. Housing and Financial Crisis

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Two Separate Challenges

- Resolve current problems.
- Reduce the probability of a recurrence of these problems.

Part 1: Current U.S. Problems

- The economy is very likely in recession.
- Housing is overbuilt and overpriced.
- Several million families will lose their homes to foreclosure in the next few years, with negative spillover effects on their communities.
- The financial system is reeling, and intermediation—lending to households and businesses—is impeded.

Dealing with Foreclosures

- Provide mortgage counseling.
- Pass legislation clarifying mortgage servicers' responsibility.
- Encourage servicers to write down mortgage principal.
- Provide funding for state and local governments to deal with foreclosed properties.
- Change bankruptcy law regarding houses.
- Expand eligibility for FHA-guaranteed loans used for refinancing.

Dealing with Financial Fragility

- Keep liquidity flowing.
 - The Federal Reserve has a lot of resources to continue serving as lender of last resort to key institutions.
 - Rescues (like Bear Stearns) are appropriate as long as shareholders end up with very little.
- Encourage/force recapitalization.
 - Financial institutions should reduce dividends and search aggressively for new investors.
 - We should apply regulatory pressure to accomplish this.

Should More Be Done?

- How would we know if these steps aren't enough?
 - Cascading defaults and institutional collapses.
 - Drying-up of lending to households and businesses.
- What would be done then?
 - Outright purchase of asset-backed securities.
 - Government equity investment in financial institutions.

Part 2: Avoid Future Problems

- Financial markets will always experience swings between confidence and fear, but we can reduce the frequency, magnitude, and broader consequences of the swings.
- Deregulation is not the main culprit. Rather, regulation failed to keep up with financial innovation. More, and better, regulation is needed—but it should be designed to limit the excesses of innovation without stifling innovation altogether.

Principles of Regulatory Reform

- Strengthen private market discipline: increase transparency and align incentives.
- Enhance government oversight on behalf of both borrowers and lenders/investors.
- Together with the natural private response to this crisis, these regulatory changes should lead to less risk-taking (more capital) and less leverage (more liquidity).

Regulation of Mortgage Lending

- Adopt simpler disclosures.
- Restrict mortgage offerings to some extent.
- Strengthen federal-state cooperation on enforcement.
- Regulate mortgage brokers.

- Require originators to retain part of mortgage risk?
- Encourage homeownership less vigorously?

Regulation of Comml. Banks

- A lot of risk that was supposedly dispersed ended up back on the balance sheets of commercial banks, but in less transparent form and less well-capitalized.
- Modify accounting standards for off-balance-sheet assets and liabilities.
- Are there other ways to improve risk management, paying attention to both capital and liquidity?

Regulation of Investment Banks

- If the Federal Reserve will lend to them directly, then they should be supervised by the Fed.
- But what sort of regulation should the Fed impose?
 - Higher capital requirements?
 - Less short-term borrowing, so greater liquidity?
 - Risk-management methods?

Regulation of Rating Agencies

- A big source of our current problem, but solutions are not clear.
- How can conflicts of interest be reduced?
- Should the government provide closer oversight?

Other Regulatory Issues

- Should we regulate other types of intermediaries, such as hedge funds, bond (“monoline”) insurers, etc.?
- Should we regulate Fannie and Freddie differently?
- Should we regulate financial instruments themselves?
- How can we allow for easier unwinding of problems?
- Who should regulate what?
 - State versus federal regulators
 - Several federal regulators

Concluding Thoughts

- No single solution: Many changes are needed, and even together they will not necessarily prevent a recurrence.
- Don't let a vision of an ideal regulatory system block movements toward a better system.