The Brookings Institution

A Hamilton Project Policy Discussion
The Future of Housing and Credit Markets

Uncorrected Transcript

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**Robert Rubin:** Good morning. I'm Bob Rubin. On behalf of all my colleagues at The Hamilton Project, we welcome you to our discussion this morning with respect to housing and the credit markets.

As all of you know, the Hamilton Project was begun about three years ago, designed to set forth an economic strategy for our country in the face of a transformation of global -- transformation of circumstances in the global economy.

Our guiding view has been that the United States can thrive in this rapidly changing global environment, but that we have enormous challenges to meet in order to realize the potential. We need to meet our challenges. If we fail to meet our challenges, we could have serious difficulty.

Our focus has been predominantly on the long term. We focused on fiscal discipline, the restoration of sound fiscal conditions, healthcare, energy, infrastructure, technology and much else.

In that context, we've had periodic events with papers that have been subject to rigorous academic peer review. And then panels with outstanding panelists, practitioners, policy analysts and academics. We've also had a number of events that have dealt with more pressing issues, where there hasn't been time for our usual process and there we've had a panel, once again, with outstanding panelists and practitioners, policy analysts and academics.

Today's event is a mixture of the two. Firstly, as we all know well, there's an enormous, immediate and most serious challenge facing our economy in our financial markets.

And that crisis poses serious questions with respect to housing prices, mortgage markets and families losing homes. And those are immediate issues that must be addressed.

And, secondly, also longer term issues in these same areas, with respect to mortgage credit, access to housing, affordable housing, and the structure of our mortgage markets.

Our program today is designed to contribute to addressing this broad array of issues. Our first two panels are directed largely toward the longer term issues. And the third panel has leave to go wherever it wishes. And I suspect will probably focus in fair measure on today's crisis but also with comment on the longer term.

I would outline the program in just a moment. I'll introduce the speakers. I won't go into their resumes. Those are in your packets. But let me first say this is really a terrific, terrific program at a very important time with respect to a critical issue.

There is great intellectual vigor and that is combined with great practicality. True, both in the papers and in the panelists. For all that, I'd particularly like to recognize our director, Doug Elmendorf and our Managing Director Karen Anderson, who put all this together.

Our opening program is entitled: Reforming low-income housing assistance. The moderator will be Bruce Katz, who runs an outstanding urban affairs program at The Brookings Institute called the Metropolitan Policy Program. The paper is authored by Edgar Olsen, Professor of Economics at the University of Virginia. The discussants on the panel are both deeply experienced in community development affairs.

One is Bart Harvey, Former Chairman of Enterprise Community Partners, Enterprise Community Investment. And the other is Buzz Roberts, Senior Vice President and Director of Policy and Program Development for Local Initiatives Support Corporation. That is to say, LISC.

The second panel is entitled New Mortgage Ideas. This panel will be chaired by Doug Elmendorf, Director of our Hamilton Project. There will be two papers. One by my former colleague of Treasury, now Professor of Law at the University of Michigan, Michael Barr; and the other by Andrew Caplin, Professor of Economics, New York University and Co-Director of NYU's Center of Experimental Social Science.

Then finally we'll have a roundtable that's entitled the State of Housing and Financial Markets. This panel will discuss the full range of issues with respect to housing policy and mortgage policy, with, as I said a moment ago, a lot of focus on the immediate crisis and some observations about the longer term.

The moderator is Greg Ip, U.S. economic editor for The Economist. The three discussants are Sheila Bair, the Chairman of the Federal Deposit Insurance Corporation, the FDIC; Eric Mindich, Chief Executive Officer of Eton Park Capital Management, and Lawrence Summers, Charles W. Elliott university professor, Harvard University and former United States Secretary of the Treasury.

This panel will provide an interchange between truly outstanding individuals who have had experience in the world of policy, government and markets.

We have a great program ahead on issues that are vital for the moment and for the longer term. And with that, let me turn the podium over to Bruce Katz. Bruce.

**Bruce Katz:** First of all, I want to commend Secretary Rubin and Doug Elmendorf and The Hamilton Project for starting off a forum on the future of housing with a focus on rental housing, and particularly low-income rental housing.

Rental housing, as many of the people in the audience know, does not get much respect in this town. And as many people have commented, I think one of the fall-outs from the mortgage crisis or one of the take-aways from the mortgage crisis is an understanding of how unbalanced federal housing policy is and how tilted it is to home ownership.

In a few minutes we're going to hear from Ed and then responses from Buzz and Bart. Just a little context. A few facts are always dangerous in these situations.

But a third of Americans rent. They are disproportionately poor. They are disproportionately minority. They disproportionately live in central cities.

About 70 percent of very low-income renters pay more than 50 percent of their income for rent. Figure out how you'd survive if that's what you were dealing with. And almost half of all renters pay more than 30 percent of their income for rent, and that's generally the threshold we use for affordability in this country.

So we have a mismatch between wages and prices for renters, and we're going to talk about how the federal government has responded. We also have a spatial mismatch between where many of these renters live and where jobs and employment and opportunity, either for families with children or even for elderly, principally reside as our economy has decentralized and metropolitan areas have grown in their broad geography.

So these are the sort of larger contextual questions that we have to deal with, with rental housing in the United States. Going back to the 1930s, the federal government has responded to this in basically two ways.

It has tried to expand the supply of affordable housing, as Ed will talk about. We have inherited a whole bunch of programs and policies going back to the New Deal, whether it's public housing, whether it's FHA insurance programs, whether it's the Section 8 new construction efforts from the 1970s, whether it's now the low-income housing tax credit, that's where the bulk of the focus has been in federal housing.

But starting in the 1970s we started to focus on tenant-based assistance, direct assistance to renters, and we now have two million households receiving vouchers.

What Ed is going to describe and for some in the audience this will be deja vu, we've been here before.

We can go back and Bart can recite from memory conversations, debates we've had about what's the best form of housing assistance that the national government should deliver. Should it be assistance at developments, units-based assistance versus assistance to renters, tenant-based assistance.

But I think a lot is at stake here. I think there's clearly a sense, particularly now, not just because of the immediate crisis, but because of the growth in capacity of state and local government nonprofit practitioners, the whole maturation of housing policy and programs over a long period of time.

We really, I think, are here to begin the conversation of whether those federal rental housing, a policy in the next decade or so. The context is large, but I think today's panel is well suited to meet it.

With that, let's start with Ed Olsen.

**Edgar Olsen:** Given the current situation of housing and financial markets and the responsibilities of the congressional committees that oversee low-income housing policy, these committees will not be able to give thoughtful consideration to reform low-income housing policy in the near future.

However, I was asked to write a paper on this topic, and that's what I'm going to talk about. My proposals are designed to get more from whatever amount of money is spent on low-income housing assistance.

They address what I consider to be the two major structural shortcomings of the current system. These are: Its excessive reliance on unit-based assistance; that is, assistance tied to the occupancy of specific dwelling units. And the failure to offer assistance to all of the poorest families. My view on the first matter is based primarily on evidence on program performance. Most importantly, but not exclusively, evidence on differences between tenant-based and unit-based assistance with respect to the total cost of providing equally good housing.

Unit-based assistance is much more expensive. The evidence implies that it would be possible to serve current recipients equally well. That is, provide them with equally good housing for the same rent and serve many additional households without spending more money by shifting resources from unit-based to tenant-based assistance.

Tenant-based assistance also has another major advantage. It allows each recipient to occupy a dwelling unit with a combination of location, size, amenities and condition, that that recipient would prefer to the unit that they would be assigned under a program of unit-based assistance, while still ensuring that people live in units that meet minimum housing standards.

My support for an entitlement housing assistance program for the poorest families is based not on evidence on program performance but simply a conjecture about taxpayer preferences. Namely, if a taxpayer had a given amount of money to divide between two people and that taxpayer cared equally about those two people, then the taxpayer would divide the money equally rather than giving it all to one of the two people.

The current system offers large subsidies to some families and none to other similar families. So based on these considerations, I argue that we should deliver housing assistance exclusively through a program of tenant-based housing vouchers. And this program should serve all of the poorest families that want to participate.

Achieving this outcome requires modifying and expanding the Section 8 housing choice voucher program and gradually shrinking all other low-income housing programs.

The paper proposes a transition that benefits many current recipients and hurts very few of them. It shows that after the transition is completed an entitlement tenant-based housing voucher program that spends the same amount of money would indeed serve many more households. Specifically, the paper contains estimates of the effects of replacing most of HUD's programs with a specific entitlement housing voucher program that I designed.

This specific entitlement program would serve 2.4 million additional families for the same money.  It would serve more whites, blacks and Hispanics, more elderly and non-elderly.  More families living in metropolitan areas and more families living in non-metropolitan areas.

The paper discusses the transition for the three broad types of housing assistance, public housing, privately-owned subsidized projects and housing vouchers.  And just to give you a flavor of the transition I have in mind and given the small amount of time I have, I'll briefly describe the proposed transition for public housing.

So currently HUD provides housing authorities with about $7 billion a year and operating in modernization subsidies for the public housing projects.  My proposal would not change the amount of federal money available to any housing authority.  But it would greatly alter the restrictions on the use of this money and increase the total revenue of housing authorities.

It gives each housing authority the same amount of federal money as it would have gotten with a continuation of the current system so that no authority would be able to object to the proposal on the grounds that it would have less to spend on its clients.  With one exception, the proposal requires every housing authority to offer each public housing tenant the option of a tenant-based voucher, affordable voucher, or remaining in their public housing unit on the previous terms.

With one caveat, this ensures that no public housing tenant would be hurt by the proposal and each tenant that accepts the voucher would be helped, because they're getting something they preferred to what they would have had otherwise.

To ensure that housing authorities can actually pay for these vouchers with the amount of money available, the subsidies level in this voucher program would be adjusted so that in the unlikely event that all public housing tenants took the vouchers and left public housing, there would be enough money to pay for those vouchers.

The proposal would allow housing authorities to sell any of their projects to the highest bidder.  This would provide additional revenue to improve the remaining projects that provide vouchers to additional families.

When a project is sold, the remaining tenants in that project would be offered the choice between vacant units and other public housing projects or a housing voucher, as is the current practice in Hope VI program.  When public housing units are vacated by families that accept vouchers, it would allow housing authorities to charge whatever the market would bear, whatever rent the market would bear for the units vacated.

This would provide additional revenue to housing authorities without additional government subsidies.  So each year, some of the people who took the vouchers and left public housing would leave subsidized house altogether because, for example, their incomes would rise to the level where they would not be eligible for a subsidy.

I would take the money that was used to provide them with vouchers and provide it to additional people.  This would ensure that the money that would be otherwise used for public housing would continue to serve at least as many households.

If these proposals were adopted, public housing authorities would gradually shed the dysfunctional public housing program of the 20th century and focus their efforts in the 21st century on making their cost-effective housing voucher program even better.

The public housing program would wither, but public housing authorities would do a better job in helping low-income families with their housing without spending any additional money.

**Bruce Katz:**  So this is a pretty dramatic proposal.  A seismic shift in the way the federal government would deliver housing assistance.  What Ed didn't say was that one of his proposals is to obviously end the low-income tax credit program.

Our next two speakers, Buzz and Bart, basically run the two most important nonprofit housing intermediaries in the United States, which have used the low-income housing tax credit to stimulate the production of affordable housing supply.  Since this is a Brookings event, it will be a civil conversation.  But you just put Buzz and Bart out of business.  But we'll move from there.

What I'd like to do is start with you, Bart, and perhaps disaggregate the response in the following way, because what Ed calls for is to make housing an entitlement in the United States for very low-income renters.  Obviously through a particular delivery system.  So perhaps a minute or so on:  Is that the kind of shift we should be talking about?  Right now, housing is a lottery and only about a quarter of eligible recipients do get federal help.

The second piece is this question of how to deliver.  How do we differentiate on cost, on coverage, on access, between unit-based assistance and tenant-based assistance, given your experience over the last 25 years.

**F. Barton Harvey, III:**  Well, let me start by saying, Bruce, that this has been a debate raging for many years.  It's worthwhile to look it.  Ed's paper makes a great deal of sense.  And I think Buzz and I would lay down any arms we have at the table right now if there was a full entitlement, with a fully funded voucher that went to everyone who is eligible, with the cost of housing increase in it and easier rules for landlords to take it. There may be enough purchasing power for the supply to follow suit.

The reality is that in times of budget deficits, et cetera, what happens to the vouchers is, right now, assistance is only going to a quarter of the people who are eligible.  That isn't expanding.  That's contracting.

There are cuts in the level of funding.  The government is an unreliable funder.  The landlords don't like taking this voucher.  It doesn't go into the areas of opportunity where landlords have other choices.

And so there's a real politics that goes on in this.  And we would be all for an entitlement. That's what Buzz and I worked our lives for, is that people have decent, affordable housing in this country. I just don't think it's going to happen right now. And then you have to look at the set of policies that you need. And the short answer is both ends.

And in certain cases, like preservation, where the government's invested a huge amount of resources, place-based subsidies are needed to preserve those units to keep them affordable in areas where there are opportunity for low-income people.

In other cases, public housing, which was throughout this paper, I think there's probably two or three different viable opportunities that go. In certain cases, vouchers make a great deal of sense. In other cases, a place-based subsidy makes sense for the investments that's already been put into the public housing. And there's the third which is partial development and a Hope VI-type of mixed income development and vouchers for those who get displaced in certain areas.

The final point I'd make is that in any real asset with our economy the way it is, over 30 years things change dramatically. And you have to remake plays. And vouchers doesn't necessarily do that. And it's not always the most cost-effective means of looking at your previous investment in what else needs to be in the place that has changed as a result of the quick changing economy that we're looking at now.

So I'd say that the paper is well argued. We'd all love an entitlement. It doesn't look like it's going to happen now. And you need a number of different options that are both production-oriented and demand-oriented to deal with the landscape we've currently got.

**Bruce Katz:** Maybe dig in on this place-making role that project assistance has had. I mean, in the past, when you think about some of these public housing developments, particularly those built in the '50s on the so-called wrong side of the city, wrong side of the region, it undermines place. But have we learned enough that the way in which we're delivering low-income housing tax credits, for example, are stabilizing and then helping to vitalize neighborhoods?

**Buzz Roberts:** I think we've learned a great deal. We know it works now. The low-income housing tax credit has a remarkable track record of success. It's performance-based. The investors only get to claim and keep their credits if the housing is built on time and on budget, if it serves the right tenants; it has restrictive rent for an extended period of time and remains in good condition. Because of that private sector oversight, project selection decisions are devolved to the states who are closer to the local community issues, and because there's really been a partnership among nonprofit and for profit developers, of private investors, city and state and federal government.

There are a lot of different roles that are being shared and delivered in an effective way. We've seen -- and there's a lot of academic evidence to support a great deal of revitalization that results from these housing investments, especially in lower income communities.

We're not really -- at LISC, we're not really in the housing business; we're in the community building business. Our mission is to help build sustainable communities.

And we see these housing investments as playing a unique role in catalyzing a much broader revitalization process. That includes home ownership. Includes grocery stores and other retail.  Child care facilities.  Youth recreation.  All kinds of elements that any community needs.  And the results often lead to reduced crime, a stronger social fabric. Of course, greater revenues for the locality and a reduction in social need.

Much more of a mixed income strategy, much more of a market-based strategy.  A strategy that says these should be communities of choice.  And that's really something that is a very important outcome of these kinds of investments.

I agree with Bart.  Vouchers are really important.  We really strongly support them.  And if we could get an entitlement voucher program, that would be terrific.  But it's not the only objective here.  It's like telling a carpenter he can have a screwdriver or he can have a hammer, but he can't have both.  No good carpenter wants to be so restricted and we shouldn't be so restricted.

**Bruce Katz:**  Circling back to Ed, can you respond to this cost issue?  Because on the surface what Ed is basically saying is that if we shifted from unit-based assistance, public housing, the different kind of projects and programs we've had, to vouchers, we could serve an additional 2.4 million people right off the bat.

You know, at sort of a high level that sounds pretty attractive.  Are the numbers wrong?

**F. Barton Harvey, III:**  Well, there's more than one way to look at numbers.  Ed cites some studies that the General Accountability Office did earlier in the decade, and that does show that the cost of building a tax credit project is about, on the average, 15 percent greater than providing vouchers over the same 30-year term.

That intuitively is sensible, right?  To build a new home is going to cost more than to use an old home.  And the typical voucher home is 35 years old.  But, actually, when you look at the GAO numbers a little more closely, there are some assumptions in there.

So, for example, if rents go up faster than inflation or faster than income, then the cost differential melts away.  And especially in metropolitan areas.  And that's right in the GAO report.  And that makes sense.  And we have seen, by the way, this phenomenon in the high growth areas, in the high cost markets of the country, where we want to make sure we're providing housing opportunity and where the need among low-income people is the greatest and we want to serve them.

So the cost differential, I think, is probably a lot less than is portrayed.  And right now the government is spending about $8,000 a year on vouchers.  About $6,000 a year on project-based subsidies.

And so shifting from a lower outlay subsidy program to a higher outlay subsidy program isn't going to save money.  It might be a good thing to do.  It might be a good investment of money.  But I don't think we're going to get any savings there.

**Edgar Olsen:**  Let me add on to that just a couple of issues.  You're seeing the supply of housing that's affordable shrinking every year, so that what Buzz is talking about, which are the real increases in the rent.  Remember, voucher is a one-year payment that goes up if it's going to achieve the aims that are outlined in this paper.

And you're shrinking your supply.  I think you have nine million households making between 11 and $18,000 and three million affordable units for them.  And that supply keeps dwindling away, which means that prices continue to rise, which means you have to pay more for your voucher over time.

So you just come back logically to saying you gotta do something to increase the supply that is out there that's available for these units.  And you'd have to keep raising that rent if you're really going to get them into places of opportunity.  Because landlords do not -- if they can get someone else to pay the rent rather than a voucher holder, they'd rather not go through the bureaucracy of the voucher holder.

So there really is a premium that's needed if you're really talking about getting people to opportunity.

**F. Barton Harvey, III:**  There's one other aspect of this, too, which is if we really did increase the demand at the low end of the market, it would have a price effect.  Unless you're also increasing supply.  So we have a somewhat balanced approach now.  But if we were to really have an entitlement and really flood the market with a lot more demand at the low end, that's going to drive up rent and drive up costs as well.

**Bruce Katz:**  I'm hearing a couple things here, because we should celebrate consensus if we can find it.  And here, obviously in the housing communities, there's always been support of moving towards full coverage.  Entitlement, whatever we want to talk about it.  I mean the voucher program is only one vehicle.  We could talk about the earned income tax credit, perhaps, in some other respects.

I hear Bart saying perhaps your idea of a public housing demonstration with a segment of that inventory to sort of move that to vouchers, is something we probably should just do and study and evaluate and assess and the next time we get and have this conversation we'll have more to rely on.

But then I sort of hear this real pushback over the general level about the inadequacy of supply, what would be the effect of vouchering out.  And then also, and something you should respond to, this revitalization aspect of housing policies, not the old policies, but the new version.  Hope VI, the best of the tax credits.  So to what extent does your paper take into account supply and also this revitalization piece.

**Edgar Olsen:**  So there are many things to respond to.

**Bruce Katz:**  We only have --

**Edgar Olsen:**  The first one I want to focus on, because there seems to be a lot of consensus, that the ideal would be an entitlement housing voucher program that served all low-income people.  And the usual objection to that is it's just far too expensive.

But I think the reason people think that is they think if we continue to make as many people eligible as we currently make eligible, which is more than 40 percent of the population, and if we continue to use programs that were very expensive for the housing provided, yes, it would be very expensive.  That's true.  But we don't have to do that.

And that's why I designed this housing voucher program that is analyzed in the paper to have exactly the same costs.

So you can't object to my proposal for an entitlement program on a cost ground. It will not cost any more than the current system. And so I think that's the first point to get across.

Going actually to the last, Bart's last point about the lack of affordable housing, meaning housing that has relatively low rent, the least costly way to get people who are not in good housing into affordable house is simply pay a part of the rent. Use housing vouchers to pay a part of the rent. That's what the research shows, that that is the cost-effective approach.

You don't have to build new units. In fact, today building new units is really lunacy. The rental vacancy rate is at a historic high right now. One in 10 rental units are vacant in this country.

Owner vacancy rate is also at a historic high right now. In the rental markets, in 1970 to 2000, was always between 7 and 8 percent rental vacancy rate. Now 10 percent. Today, especially, we don't want to be building new housing.

But just in general, even if the vacancy rate is low, the voucher program works very well to get people into units. It just pays a part of the rent. Units that would not be affordable without the voucher subsidy are affordable to the household with the voucher subsidy. And if you don't have enough units that meet minimum housing standards, those units can be fixed up. 50 percent of the units in the Section 8 voucher program are improved to meet the program standards. They did not meet the program standards at the time they were first inspected.

You don't need new construction to have additional units that meet minimal housing standards. Just fix up the units you have. I say today we have plenty of units. I say that even in tight markets the voucher program works well because you simply fix up the units you have to make them better and you give people a voucher subsidy to help them pay the rent, which makes a unit that otherwise would not be affordable be affordable.

**Buzz Roberts:** I can take a city, Baltimore, which was once a million is now 600,000 people. There are vacancies in that rental market. It depends on where you're going to put people and where those vacancies are and what the rates, the expected rates to be paid are.

So I look at that vacancy. We've seen it from HUD over and over again. And you need to -- you need to really delve into where are those units, where is that vacancy rate coming from, what is the cost level and rent levels that are expected from temporary dislocations, and would vouchers really satisfy that over a real estate cycle. And I think there's lots of issues there. As you get on the ground you see more and more of them.

**Bruce Katz:** Are we being smart with the production programs we have? Are we not acquiring -- particularly in this market, are we not acquiring housing and then putting it towards, putting long-term affordable restrictions on it?

**F. Barton Harvey, III:** I think we're seeing it in a local market basis, the tax credit, for example, is used much more now to rehabilitate and preserve existing stock and less to build new than was the case in the past. That is a response of policymakers at the state and local levels to these new circumstances. And I think you're seeing the credit being used in an increasingly cost-effective manner in that regard.

I might add that it's certainly true, if there are minor improvements that a landlord has to make to get his unit available for the vouchers, he can do that and may well do that.

But that doesn't mean that major rehabilitation is going to work. It doesn't mean that supply shortages in very strong hot markets are going to be addressed.

It doesn't mean the catalytic neighborhood project that have a much broader effect on the entire community are going to get done. And it doesn't mean that properties that serve tenants with special needs such as the homeless are going to get built. And vouchers simply can't do those jobs. They are a great tool. I love them. But they are not the -- they are not the only tools in the toolbox. And they don't address every need that we have.

**Bruce Katz:** Let me sort of quickly shift here. Because here's the starting point: 70 years of policy. We basically have built -- 70 percent of our assistance has gone to projects, public housing through tax credit. We have another two million people served with vouchers, about 30 billion spent out of HUD a year. Another four, five billion spent out of the tax credits.

States and locals are stepping up with their own trust funds. We have a system at this point that has a certain logic to it and we could argue has gone through a period of reform and transformation really since the mid-1990s. Where do we go from here? Because the starting point is still we're only serving a quarter of those people eligible.

And the affordability issues are getting worse, not better. Particularly in the aftermath of this mortgage crisis. So if this is not the big fix and the big shift in policy, where do we go that has some transformative effect? Because right now my sense is most of the rest of the conversation is about just iterating the ball, let's expand the loan housing credit by 20 percent. Or let's fully fund the backlog of modernization needs and public housing probably around 32 billion. So is there a big fix that is different from what Ed has proposed? And you can throw one out if you want, Ed.

**Edgar Olsen:** Mine's in the paper.

**Bruce Katz:** That would be a typical Brookings response. Almost like a lawyer's response: I argued this now but now I'll argue this.

**Buzz Roberts:** Let me ask Ed, what criteria would you take for your paper and what would be the additional cost? Because if you say right now a quarter of those people that are -- and Bruce is right, we need a big new strategic view of how we get at this issue, and we're not getting at it. We're not getting at it in the home ownership side or rental side. So let's just be straight out and true. But there's a big price tag that comes with it. And I didn't see it in your paper.

**Edgar Olsen:** No, the paper estimates the effect of the housing -- an entitlement housing voucher program that has exactly the same costs.

**Buzz Roberts:** But what you do, you just make less people eligible. You take it --

**Edgar Olsen:** I don't just do that. I do that. That's true, I make fewer people eligible. That is a part of it. I don't think we should be making 40 percent of the population eligible for housing assistance and then not offering assistance to some of the very poorest people in the country. Those aren't my values.

**F. Barton Harvey, III:** Even if you look at this, the people with the worst case housing needs, these are very low income people, much lower than eligibility ceilings are, who are paying at least half of their income on rent. That's five million people.

At the average cost of a voucher today, of $8,000 per year, that's $40 billion per year forever to serve that population. On top of what we're doing now or even when you're reducing, taking somebody else out of another program, you're going to have to give them a voucher to make them whole. That's really, I think, beyond even our ambitions.

**Edgar Olsen:** I think several things. You're assuming that the voucher has to be as generous as the current Section 8 voucher. I think that assumption is wrong. It doesn't have to be that generous. We operated an entitlement housing voucher program to the smallest metropolitan areas in the 1970s, and the voucher was about half as generous as that. So it doesn't have to be that generous.

The other thing, you should not assume that everyone who is offered a voucher will participate. Participation rates are not 100 percent. They're not 100 percent -- they're 60 percent in the food stamp program. 60 percent. Not 100 percent. So you need the -- the voucher doesn't have to be as generous as the current Section 8 voucher. We certainly don't have to make 40 percent of the population. In my program, in particular, one specific proposal, it was like 15 percent. Let's focus on the poorest 15 percent.

**Buzz Roberts:** I think five million would be within your poorest 15 percent. And I think you begin to lose a base of support. I think the other big issue is that as you go to renew and increase the costs, what inevitably has happened in this environment is you get squeeze-back. The voucher becomes less viable for getting people to opportunities. Mobility is one of its key issues. And you are again reconstituting poverty into those places that will take that voucher.

And you're not expanding the supply. I think just a couple of -- so your big strategic view is that I don't think there is an answer -- there is more funding. If you hear the funding numbers, they are large. If you're really going to go after any -- even the poorest of the poor, you're going to -- you're going to need to increase the funding in a time when it seems to be going elsewhere into other things.

And so my answer to you, Bruce, would be that the current system has evolved. It is both production and vouchers. There are experiments going on. And you need to make this system more constructive, more constructive between HUD and states and localities. You've got to get red tape out of some of the programs.

You've got to make them work better, which Ed suggests.  You need to look at where vouchers will work and where it won't and where tax credits and other means will and won't work.

And let me criticize the tax credit program in saying it does not get the units to the areas the most opportunity like it needs to do.  And there's a whole set of suggestions we have about that that ought to occur as well.  And preservation is absolutely critical.

So you take this patchwork.  You make it work better.  You make sure HUD's not working against it.  The GSEs, nobody has mentioned here, they were a critical and important part.  They are a critical part of the rental market today.  The financing of the rental market today.  They're a critical part of the low-income housing tax credit market.  They're in play.

So I think a number of measures needs to be taken by these very large financing entities, just as they are in the home ownership side.  They ought to be in the rental side.  So far what we've heard is they say there's business as usual.  We're going to continue our financing.  We're going to hold our tax credits.  We're not going to flood the markets so far.

But you've got the issue of the strategic moving forward.  You've also got the issue that things could get a lot worse if you don't do certain things.  And then you have reform in some of the most successful programs.  And then you need funding.

**Bruce Katz:**  Quickly.

**Edgar Olsen:**  Could I just say something about this issue of the concentration of people with housing assistance?  And this is just -- this is a fact from a recent HUD report.  In the 50 largest metropolitan areas in the United States, 80 percent of the census track have at least one person with a housing voucher.  Less than 20 percent of all census tracks have a private subsidized project, and even fewer have public housing projects.

So even the current situation, the current situation is vouchers certainly spread recipients out over the landscape to an enormously greater extent than either private projects or public housing.

**Bruce Katz:**  I think the research has basically shown that over time.  And the question I think, in sort of a tight market, is particularly, as housing prices really run up in the most prosperous metropolitan area, are issues around access.  Both in the near term and over the long term.

Because we're going to be called off of here pretty soon.  This is our last gasp of rental housing.  And particularly on the large strategic vision, because a new regulator coming in overseeing the GSEs, the new Secretary, respective of who wins the presidency.  I heard Bart begin to go down to the road, which might be a smart way to proceed, really focus on the cost of production.

I mean because on the funding side, except the fact that we're in a constrained environment, but the cost of producing housing is something that we can effect, particularly by working closely with state and local governments and the private sector. And we've never really done that in any serious way for decades.

**F. Barton Harvey, III:** Let me very briefly say that both vouchers and low-income housing tax credit deals penetrate the suburbs about at the same rate as rental housing generally. The problem isn't necessarily in those programs, the problem is getting more rental housing into the suburbs and into high growth areas.

And that's a much tougher issue that gets to questions of local choice and perceptions about density and rental tenure that we have to get at. Let me suggest two big strategic areas. One, we ought to revitalize low-income communities where low-income people and moderate and middle income people as well tend to live. Because if we let those neighborhoods deteriorate, we will lose so much more housing to deterioration than we can ever hope to replace with any federal subsidy.

So, first, let's stop that bleeding. Second, this is a little tougher in this environment. I would have said where development is continuing, especially in the high growth areas, let's look at things like inclusionary zoning that can bring more low-income people into that, into those areas, into those developments in a mixed income context. That would be great.

The reason that that's so much tougher is that I think the whole country now is going through a major shake-out of overpriced housing, and housing prices are just going to have to come down. And during that adjustment period it's unclear how much development activity there's going to be in many parts of the country.

That's, though, the opportunity, Bruce, to get to your point, because now there is I think the opportunity to at least for everyone to come to the table to look at how we cut costs, because building at the prices that we've seen over the last few years simply won't work. And I think everybody, if they haven't already come to that conclusion, will come to it pretty quick.

**Buzz Roberts:** Let me throw out two more. One is the greening, the energy efficiency. All public housing, the government ought to help create an ESCO, something to go in and look at your return on making all of affordable housing energy efficient and set up a financing retrofit program. There's a number of them in the works now. It will make the long-term operation of that housing more cost-effective. We ought to do that.

Let me drop a bomb, which is the mortgage interest deduction. We ought to look at where that goes. That is the biggest subsidy for housing. And it is unequally shared. And if there is a way of financing some of the things we're talking about here to more evenly share that mortgage interest deduction, we ought to look at doing it. Because that -- don't get me wrong. I'm not doing away with it, I'm sharing it in a different way within the housing industry. And that's something that President Bush's own commission and ex-Republican Senator Connie Mack suggested. And that's a big solution.

If you look at modifications, you're talking about 10s of billions of dollars that go from households making over 150,000 to those that really need that financing over time. And you could do all kinds of extension in both rental and home ownership to make that happen and through the private sector.  But, anyway, no one will ever have a drink with me again from the home builders.

**Bruce Katz:** I think where this is evolving, and I think to a large extent I mean the paper sort of stimulates this kind of conversation.  It's a very healthy conversation.  What is the national housing vision, after 75 years of doing all this stuff?  Right?  Where are we going?  75 years, we're serving a quarter of the eligible population.  We have all these disparate needs and challenges.

It strikes me that between Bart and Buzz, and really some of yours, we're beginning to lay out, perhaps, an architecture here with the new GSE stability and apartment finance. Innovation in finance.  Focus in the near term on acquisition, particularly in those markets that have been ravaged by mortgage foreclosures.  I mean that could potentially, along the lines of what Montgomery County has done, lock up housing for the long haul.

A real focus on cost of production, which has to take into account the greening and energy efficiency, because the residential sectors that have 20 percent of greenhouse gas emission.  In a way this is a different kind of federalist partnership between the states and localities and the non-profits and the private sector.  For a long time the federal government really dictated the housing affordability market over the past 20 years.  There's a broader group of stakeholders, some real progress and innovation.

So it strikes me that maybe this is where we go next.  Right off, housing part two:  What is another vision that we could put forward that takes into account some of the heart of appearance that Ed and others have done but begins to lay out from tax to subsidy to regulations.

**Edgar Olsen:** To land use.

**Bruce Katz:** To finance, this sort of broader panoply.  And my sense that's not been done.  I mean, I think this is really a vacuum that can be filled.

**Buzz Roberts:** And if you do do that, like Ed's paper, if do that and you look at inclusionary zoning, you look at land use and look at the mortgage interest deduction, you get a financeable future of affordable housing that will meet many more people than it does now and it's within our ability to do.  At our will.

**Bruce Katz:** Questions from the audience.  Comments?  Criticisms?

**Question:** Alejandro Becerra.  I'm a former HUD employee.  In places like Phoenix, Arizona, there have been some years where as many as 18 to 20 percent of the housing vouchers have gone unutilized.  This would present a problem to the use of vouchers.

HUD has had in place for the last five years a voucher home ownership program.  And I would like to recommend that that be one of the options that can be looked at as we look forward, assess it, how is it working, how is it viable.  It may not reach the very low end that you're looking at, but it certainly may be a viable program for lower income people at the upper end.

**Bruce Katz:** Vouchers for home ownership?

**Edgar Olsen:** Yes. We have a very -- it's a very small part of the Section 8 voucher program, it's at the discretion of housing authorities whether to offer it or not. Most housing authorities don't. They only offer it to a few people. I would actually like to require them to offer it to anyone.

They don't do it because the way it's set up it's pretty administrative-intensive for them. And I think we need to work on that. But the whole system of low-income housing assistance is very skewed towards rental; whereas the subsidies for the middle and upper income people is skewed towards home ownership. I don't see any reason why we should be really skewing the system against home ownership for low-income people. But that is actually what we do now.

So expanding that component of the Section 8 voucher program I view would be a very good thing to do.

**F. Barton Harvey, III:** To add on that, there are actually more, very low-income homeowners facing severe cost burdens than there are very low-income renters. I heard on the radio this morning getting up that now the number of homeowners in America paying more than 50 percent of their income for housing, homeowners, has gone up from 7.1 million to 7.6 million. Perhaps as part of this sub-prime lending issue.

**Bruce Katz:** That's before transportation costs.

**Question:** [Inaudible]. There's been no mention of the [Inaudible] entitlement program. One that's been radically reformed in the last decade, the military housing, government housing on military installations. And the reforms have four key features which I think are spread through all of your comments. One, the cash flow goes directly to the developers and investors from the entitlement. Two, scale. In the Army program, the range from 2,000 to 6,000 units per project makes an enormous difference in achieving both cost efficiencies and effectiveness.

Third, it's progressive. It favors the lowest end of the military income spectrum. And, fourth, it's community. Built into the program are funding for everything from recreation and now, increasingly, community centers and so on.

I think in your part two, Bruce, it would be well to look at both the histories, since there is now more than a decade of history, and scale, over 100,000 units. And to see where the lessons learned might go.

**Bruce Katz:** Quick comments?

**Buzz Roberts:** I think you've got the person to do it. Sandy spearheaded that whole effort, and I think it took a while with the generals to come to your conclusions. And with Congress. But it's been a tremendous success.

**Bruce Katz:** We're going to have to wrap up. I really appreciate the civility of the panel. This could have been a food fight of major proportions. And I appreciate the interest of the audience. Thanks.

(Applause)

**Douglas Elmendorf:** Let's get seated again so we can get started.

If you can come and get seated, we'll go on to our next panel.

The theme for the second panel today is new mortgage ideas. You might be thinking that's a terrible theme for a panel. After all, isn't it new mortgage ideas that got us into the mess we're in right now? Can we as a country survive any more new mortgage ideas? Or should we say to our mortgage designers next to me: No thanks, guys, you've done enough already?

But, of course, the new mortgage ideas you'll hear about this morning have a rather different character than the mortgage ideas that have held sway in the last decade or so. Most of the mortgage developments of the past decade have increased the risk that homeowners would not be able to repay their mortgages. In contrast, the mortgage ideas you'll hear now are designed to reduce the risk that homeowners won't repay their mortgages.

As we know, the higher risk of mortgage loans came from loans that were large relative to the value of the homes. That sort of collateral or large relative to the incomes that were used to make payments. For a while, people persuaded themselves that there wasn't much extra risk. But, of course, that turned out to be an illusion. One particular vulnerability of the mortgage products of the last decade was to a decline in house prices.

And we've ended up with a record-setting decline in house prices. Because the fallout from this unwise lending has been so overwhelming, much of the policy energy in the past year has been focused on coping with that fallout, but there has been analysis and there have been policy changes designed to reduce the risk that these problems recur, looking ahead not to solving this crisis but to trying to avoid future ones.

And the papers that you'll hear this morning make important contributions in that regard.

On one level, it's very easy to reduce the risk of mortgages not being repaid. We could simply crank up, require down payments. We could tighten underwriting standards across the board. And we wouldn't have as large a risk of mortgage defaults. But, of course, we would have some other serious disadvantages. The need to build up a large amount of wealth before one buys a house can be very damaging to families that would be able to make mortgage payments, that would benefit from being able to move into a house at a younger age.

The problem with the mortgage products of the last decade is they were designed to, in many cases, to increase affordability, increase home ownership, without taking adequate account of the risks that were involved.

In contrast, the work of Andrew and his co-authors and Michael and his co-authors, are designed to maintain affordability but take accountability and try to find ways to reduce that risk. They do it in two different ways. Andrew and his co-authors put forth a new type of mortgage, one that explicitly shares the risk of home price declines between borrowers and lenders.

Mortgagers also share, of course, gains when house prices rise. These authors contend that traditional mortgages are intrinsically somewhat unstable because they concentrate that risk entirely on homeowners. And we can control the instability, as I said, just by limiting assets, or, as Andrew and his co-authors argue, we can control the risk by sharing it between borrowers and lenders.

Michael and his co-authors focus not on new mortgage design but rather on trying to guide home purchasers into mortgages that are more appropriate for them. When the government sets restrictions on mortgages, it faces an inevitable trade-off between protecting people on one hand and giving people flexibility to pursue products that are better tailored for them on the other hand.

Michael's paper tries to break through that trade-off by sorting people essentially with most people going into simpler safer mortgage products but still having the option to choose alternative products if they are really convinced they can demonstrate those products are in their best interests.

So these approaches are complementary. We can do one or the other or both as a society. I think either of these approaches would have reduced the problems that we now face, had they been adopted some years ago. So let's get right into it. I'll ask Michael to talk first and then Andrew and then we'll have a discussion.

**Michael Barr:** I have pictures, but unfortunately they're neither, they're not especially funny or interesting pictures. But they might help explain what the paper's about.

I'm really pleased to be here today. I want to thank The Hamilton Project, Bob Rubin and Doug Elmendorf and their team for having me here as part of the event today. The work I'm going to talk about is based on joint work with Eldar Shafir, who is here with me, and Sendhil Mullainathan. And any errors this morning are my own and not theirs.

There are lots of causes of the current crisis that we're in. Among the central one, the asset implosion that we have suffered in the last year and a half has been exacerbated by a lack of transparency and lack of regulation.

And during the last decade, financial innovation dramatically increased liquidity in the system but also drove a wedge between the incentives facing different participants in the system: Brokers, borrowers, lenders, rating agencies, investors and the like.

Among the causes of the problem, one central problem was that brokers sold borrowers loans that the borrowers did not understand and could not afford. And that aspect of the current crisis is the aspect to which our plan is most directly related.

So to get into this, I wanted to take a step back and learn a little bit about some insights from psychology and behavioral economics. Insights into psychology have helped significantly change our understanding of how people make decisions, including financial decisions.

And that has helped us develop new models in some areas of regulation, particularly with respect to retirement savings. But these insights have not yet permeated our understanding of credit markets.

So let's just take a step back and look at the intersection between individual psychology and the industrial organization of two markets. In this context, the market for savings and the market for borrowing.

So one central human failing that many of us share, even Ed Olsen, is the occasional misunderstanding of the ability of the effect of compounding of interest. And this leads to, in the context of savings, this leads us to understate.

What's the market response to this? The market would like us to overcome this human failing. The market would like us to save more so that there's more to invest into the productive economy. Or take the example of procrastination. People procrastinate in signing up for tax credits. Tax firms would like to overcome this procrastination to get more customers.

Let's take this failing to a different context, where the market is not so keen on overcoming human failings. One such example that you're all familiar with, it's the context of rebates.

I get lured into a store to buy an item. That's a customer rebate available. I procrastinate in returning my rebate. Stores very much like this, they increase their revenue without having to pay the rebate.

Similarly, in the context of borrowing, because of the misaligned incentives that I've talked about, firms, at least in the short term, would like me to overborrow. They would like to exploit my inability to understand compounding of interest in the context of borrowing and exploit that.

The different reactions in different markets are important because we can't just look at human failings. We can't just look at the behavioral aspects of solving a problem. We have to know how the market is going to respond to the behavioral failing.

Now, this matters for regulation as well. It matters for regulation because regulation can't simply take into account the human failing. It needs to know how the market is going to respond to the failing. And just to overstylize the potential regulatory response, one might think of regulators as holding two kinds of ways of changing the game of mortgage lending.

One is by changing the rules. And the other is by changing the scoring. Classic behavioral economically response in the form of a rule change in the savings context is the move to make retirement savings automatic. You're automatically in a retirement plan unless you choose to opt out.

So there's been significant advantage in retirement savings using this strategy. Just changing the starting point for people's decisions, you're automatically in the plan unless you opt out, a classic economic model would say that the starting point shouldn't matter at all. Turns out, it makes a huge difference for retirement savings.

So that might be an important strategy.  In a similar context with respect to 401(K) plans, you might change the scoring of the game as, for example, imposing tax penalties if firms, retirement plans are top heavy.

How does this intersect?  Well, we need to develop, think about how rules and scoring might work in the context in which the market is neutral or wants to overcome the fallibility, as in savings.

So we develop a rule change, an opt out system for savings can make a big difference in increasing retirement savings because the market would like it to.

In the context of borrowing, where the market is opposed to the intervention, we might worry that an opt out system is not sufficient.  And I'll get to that now.

So in the context of mortgage lending, we've developed an idea based on the insight that starting points matter.  We call it an opt out mortgage system.  And in our system all applicants for a mortgage loan would be offered a standard product or a standard set of products.  And that's the mortgage they'd get unless they opted out.

And the standard set of mortgages would be straightforward mortgages with easy to understand, easier to understand terms, terms that are easy to compare across different kinds of offers.

If you wanted to offer an alternative product, a firm wanted to do that, they could.  But they'd face increased legal exposure and regulatory scrutiny if they did.  Why?  Because if we use a pure opt out system, the incentive for firms to encourage people to overborrow would still be present.  We need to counteract that.  So we've developed something -- this is a horrible name.  A sticky opt out home mortgage system.  The stickiness comes from the increased legal exposure, potential for legal exposure in the event that a firm gets you to opt for a riskier alternative kind of product.

We can talk about some of the trade-offs involved in this approach in our discussion.  But we believe that this kind of approach increases our ability for consumers to make decent decisions, improves understanding of products and comparison shopping, anchors the expectations of individuals in a sound mortgage product.

And still permits financial innovation.  So I look forward to our discussion and to your comments on this in the minutes ahead.  Thank you.

(Applause)

**Douglas Elmendorf:**  Thanks, Michael.

Andrew Caplin.

**Andrew Caplin:**  So this is joint work with Noel Cunningham of NYU Law School; Fred Pollock of Morgan Stanley, and Mitchell Engler of NYU Law School.  It concerns, as Doug said, a new type of mortgage and a mortgage that we believe should have been and could now be introduced to lower risk.

So to motivate, I want you to look forward, think about four or five years from now, when the current fuss is over -- it will be -- and when it's over what we'll be left with is a lot of people refusing to lend to people who they used to lend to very readily.

You may have 10 percent down. That won't be enough. You might have a five-year credit record. That won't be enough. We're about to enter the lockout phase of the housing cycle. In this lockout phase everybody is going to get very disturbed and they may think we've got to start increasing the supply of capital; maybe we'll keep going with the government borrowing and basically borrowing on my kids' future but that might not be the best way to do it.

Maybe what we have to do is start getting the private sector back in. Because the private sector back in, they'll start edging along, removing any blocks they've put to these new mortgages, even if they introduce them now, they'll start moving them.

The political economy will dictate that you have to have the ownership rate rise back up again. And work. We're going to hit a new cycle. There will be a new collapse. We'll all be sitting here in 10 years' time.

So we need a low risk alternative. What is the low risk alternative? Introduce a second source of capital. The second source of capital has to recognize that housing is risky. Guess what? Housing is risky. That's a bit of a fantasy when you're at the higher ends of the lending scale. In essence, you own a house. A lot of lenders have now found out. Why don't we just make that official, make that true from the beginning and start sharing appreciation.

So the idea is shared appreciation mortgage. I'll give you a very simple example. You put $40,000 in a shared appreciation mortgage, put 20 percent of a $200,000 house. 70 percent of it comes from a standard mortgage. 10 percent for down payment. And if you sell it 10 years later for $300,000, what you're going to do is only repay at the termination in 10 years. No interest during the life of the loan. But what you'll pay then is a share of the appreciation in addition to the amount you initially borrowed.

A simple example, you paid quite a lot because the house went up well in value. Well, in this example you paid quite a lot because the house went up a lot. The good thing about this is, if the house went down, you wouldn't be paying nearly as much. It's sharing of appreciation.

In a case with zero appreciation, as we're currently in, you'd basically pay back what you borrowed and no more. It raises affordability. You're only paying interest on 70 percent, not 90 percent. It reduces risk. Because you're basically, when you do well, the lender does well. When you do badly, they do badly.

And surveys suggest, we've described a product of, a very simple product of this form, surveys suggest that renters understand it. The right kind of people select in and that they would choose it over the previous products.

How it would work today? It's not irrelevant. It could work today, this very day. Many borrowers are under water. The default is wasteful. Largely it's basically you're taking somebody and saying I'm going to kick you out of the house and I'm going to replace you with somebody in just as bad an economic situation as you.  How good a win is that?

So it's not a very good win for anybody.  It's just written into the prior contract.  So what would businesses have done?  What businesses would have done is renegotiated this debt.  They would have said:  Wait a second, it's not that you've gone down, your industry has gone down.

I shouldn't be replacing you with some other manager; you are not a bad manager for this.  We'll renegotiate, substitute equity for debt.  It's a debt-for-equity swap.  It's the traditional way out of trouble for a business.  Why wouldn't it be a good way out now?

It would stop the tragedy of unnecessary default.  Recover as much as possible for lenders.  And it has this kind of fair aspect that, okay, I let you off the hook a little bit now, I'll write down your loan right now.  On the other hand, should you do very well later, I should do well, too, the lender.  Why not?

So why doesn't this exist if it's such an obvious idea?  Well, in essence it's regulatory neglect.  It's not true for regulations but, rather, incoherent regulation that I think has been the problem underlying the current crisis.

In fact, we've detailed, we've looked to the letter of the law and found out exactly how the IRS could change rules with very, very quick regulatory authority and allow this type of mortgage to exist.  In essence, it's been an IRS block on this form of mortgage, a tax block.

It started back in 1983 when these were first introduced and has gone south ever since.  A single line said we will let one type of mortgage through, but anything else won't work.

So why now?  Well, the time to act is now.  We don't know many things about how the market will operate.  But they can't be answered to that regulatory change.  As Doug knows, I've been singing this tune a while.  The reason the tune hasn't improved much is because the markets don't exist, so you can still get out the same question about what would happen if.  I don't know.  Just as when we started.  And whatever it is we were waiting to see, I think it just happened.

Again, why now?  Taxpayers -- my daughters may soon own taxes toxic mortgages.  By permitting shared appreciation mortgages, Treasury could make winners of us all?  How?  You save asset holders by taking illiquid but potentially valuable securities off their books.  By the way, please let's watch that basket.  I want the securities that go into that basket to have been vetted.  They can't just be any old securities.

Save home buyers by greatly reducing defaults.  Yes.  You just rewrite and you get rid of the default, unless this person really is in individual terrible trouble.  You save taxpayers billions by giving them a financial stake in the turnaround their commitments create.

And the trillion-dollar question as I see it is will we waste this crisis?

(Applause)

**Douglas Elmendorf:** Thank you, Andrew. We had expected to have Doug Duncan, formerly of the Mortgage Banking Association, now with Fannie Mae, here today to comment on both these papers. He discovered at the last minute he was unable to join us. So that opportunity fell to me. So I will ask Michael and Andrew a few questions. And then in a few minutes we'll open it up to questions from the floor. Let me start with Michael.

Since the financial crisis began, the Federal Reserve has significantly tightened the restrictions on high cost mortgages, sub-prime mortgages, under the Hoper rules that they had been granted authority in the mid-1990s but not exercised very vigorously. And they've entered into a new set of rules that greatly increases the number of mortgages that are restricted but also imposes a new set of restrictions.

Do you think of your proposal as something that we need in addition to that, perhaps because we want to try to guide nonsub-prime, prime borrowers into the right mortgages as well, or do you think of your proposal as being in some sense a substitute for some of that if we had this sort of guidance you're proposing and we wouldn't need to make so many things strictly against the rules?

**Michael Barr:** I think the Fed has made significant progress this year that I wish they had made eight years ago and four years ago and two years ago. This is a good step. But it's not sufficient. And so let me just say two reasons why. One is it still covers a very small part of the market. And the behaviors you're talking about are behaviors that all of us have. And they relate to the market context in which they operate for all of us.

And the second point, which we make in some detail in the paper is that rule changes still leave firms with the same incentive they had before to try and evade the rules. And so the kinds of rules that the Fed have come up with are rules that firms will invest innovating, not illegally, lawfully. But it will raise the cost of borrowers and make mortgage more complicated. Borrowers will be even more convinced that the federal government is taking care of them because they have these rules, so that the mortgage they're being offered will be a safe and well-regulated mortgage when in fact the opposite is true. And meanwhile the mortgage will get more complicated in order to evade compliance of the rules.

So our strategy really is to start with a product that is simple and straightforward and say that's the product you get unless your circumstances are significantly different and the firm gets you to opt out within the set of restrictions and legal exposure that we provide.

**Douglas Elmendorf:** I'll come back. I'll turn to Andrew. The guiding principle of Michael and his co-authors' work is that of behavioral economics, that people don't behave in the rational sorts of ways that we learn as economic graduate students and perhaps they learned from you, actually, as an economic graduate student.

I want to think about how the lessons of behavioral economics might affect our view of the desirability of some features of the shared appreciation mortgages.

For example, tradition in America is that people save for their old age partly by making mortgage payments. And the days when one put down a 20 percent payment, did nothing fancy, over the course of the subsequent 30 years one would pay down that mortgage. If one sold the house later, one would have a significant nest egg.

Seems there's some chance, if we move to shared appreciation mortgages, that what people should rationally do with the money they save by not making such large mortgage payments, is to save that, to have the same lifetime path of consumption they would have otherwise. They should save that extra money. So when they get to retirement, they sell the home and a lot of that money does go to the bank, they'll, nevertheless, have done the savings on their own.

But that requires a shift in people's understanding. I worry about that. A second related thing problem I worry about, is if one judges the size of one's home in some rational calculation relative to income, then one might end up making roughly the same decisions with a shared appreciation mortgage as with a regular mortgage.

But if one instead says what's the largest home I can buy given that I can make a payment of X dollars a month toward the mortgage, with your clever plan, people can now all buy bigger houses, which will, again, seem fun and rewarding at the time but may later lead to regret. Am I right to be concerned about how the lessons of behavior of economics would affect the way your plan would play out and are there ways to protect people against those?

**Andrew Caplin:** I think there are two of them. One is the short run issue, which is right now many of the issues to do with how big a house would people get, would they overdo it aren't the issue. So it's this immediate issue, which is can we do something right now to shift risk in a fairly short run.

Then that would give time for the market to kind of learn its lessons. Now, I do believe -- I would never stop thinking. I would monitor every bit of this. But let's think about the way people would initially use it. The most obvious source of demand, the paper goes into this, the most obvious source of demand and the one that surveys suggest is clearest is to move in more quickly.

I wanted to buy. I couldn't buy the right house right now. Buy the right house now kind of would be the slogan. And I know this.

So basically what you would do is initially get people in the early part of the lifecycle buying up. Toward the end of the lifecycle there's every reason to believe they would pay you down to zero. This is in essence a riskier form of house finance.

On average it might be more expensive. On the other hand, in the times when it should be cheap, it would be cheap. That would be the point. So I think people as they got safe in later life would generally pay this down go into their retirement the same way.

On the other thing to note is that right now, while the idea is that the house is a great way to save for retirement, the reality is that most people, when they retire, stay in the same house, don't move down, and haven't found ways to make that asset liquid at all.

And that's a whole other subject, which is how can we get people to use their houses better in retirement. Very worthwhile, but a little different.

**Douglas Elmendorf:** Thank you. Let's go the other way, Michael. Let's think about the lessons of Andrew's paper for your thinking.

You have, under this plan there's some set of mortgages that receive a Good Housekeeping seal of approval from the government. It would be an important question what mortgages fall into that bucket.

One of the analogies you drew, which I think is quite important, is the savings debate, how to rate people's savings. And literature has shown very clearly that when we sign people up for 401(K)s, let them opt out, many more save. That's fairly straightforward because it's pretty compelling that almost everybody should put enough into their 401(K) to at least receive the employer match.

So the theme from which one is opting out is a good thing for almost everybody. For mortgages, this seems less clear to me. The diversity of people's financial conditions, ages, understanding of contracts and so on, is so great. It seems less clear to me what the particular right opt-outable mortgages are. And one particular example might be shared appreciation mortgages.

So what Andrew was arguing essentially is that the traditional 30-year fixed rate mortgage is actually not the right product for most people. Is there a risk we're going to enshrine that even more with what you're proposing, or do you think shared appreciation mortgages should be added to this set? And, in general, how do we think about that innovation in mortgage products?

**Michael Barr:** Those are three really hard and interesting questions embedded into one. So let me just say that first, in a savings context, you know these are obviously highly stylized facts we presented, even in a savings context they're quite difficult decisions about the appropriate starting point.

So what's the right allocation that you opt out from? What's the right contribution level that you opt out from? You can end up forcing people to -- forcing people, with quotes, to undersave from where they would otherwise if you set those in the wrong place. So even in the context of savings, it's a difficult question.

In the context of borrowing, I think you're right, that setting the default products or set of products is really an important task. I think that the basket may include more than one option, and not just a 30-year, but also, say, a 5-1 ARM or other kinds of products. Those products potentially could include a shared equity feature. Although, the product that you've described is reasonably complicated for the average person, I think, to process and understand.

So you may have some hesitancy there. The last thing I would just say on that point is we discuss in the paper in some more length the idea of potentially having a smart default. These are defaults that are adjusted depending on key borrower characteristics.

So, for example, if you're an individual who comes in with rising income prospects, you are likely to be offered a different set of mortgages, perhaps adjustable rate mortgage, rather than a 30-year fixed rate mortgage. Those could be income or age or other characteristic-specific products that are grouped together and bundled in what we call a Smart Default.

**Douglas Elmendorf:** Thank you. Andrew, let's turn to a different aspect of shared appreciation mortgages. Let's talk about securetization. So the way in which we have developed for the last several decades to channel money into housing finance is by the mortgage issuers selling the loans, securitizing them.

Presumably, for shared appreciation mortgages to really take hold, they would need to be securitized. And those securities would need to be desirable to investors. Can you tell us how you think that would work?

**Andrew Caplin:** Yes, absolutely. That was the original motivation, which is that it's a much more explicit statement of the actual ownership that underlies a high risk mortgage, is that there's a partial equity. So you don't -- you shouldn't -- one would treat it as debt instrument. A little bit of a lie going on. Everybody participated.

Then you went to entirely the wrong group of people to stick a triple A rating on it. I mean they assess debt. They don't know anything about the equity component. They don't understand the value of a house sitting on a particular block.

They have never studied that; but, nevertheless, they're sticking an A rating on something because it came in the door nicely.

So I think what you would really need to do, and what would be motivated by packaging up these securities, is people would actually start studying house prices. They would say you know what, when you lend to a high loan-to-value ratio, you are in fact interested in the value of the underlying collateral. That's why you assessed it.

So now you're interested in the value of the underlying collateral initially. You're also interested in how that value will evolve over time. Therefore, you would set up a cottage industry would have to set up to start valuing houses.

They would say, well, one thing we never realized we were actually loaning against houses. So what would I do.

**Michael Barr:** Call them appraisers.

**Andrew Caplin:** Right. We call them appraisers from the good list of appraisers. Not the bad list of appraisers. So that there was a lot that was common knowledge in the industry about how appraisals were being done.

Now somebody is actually interested in the value of the house because they're about to directly invest. If you've overpaid, they send the appraiser off the good list and the appraiser off the good list says this is junk. And they literally advise you, you should not be buying this house and you can't buy it and share equity with us because we're not willing to put up our 20 percent for this house for which you are overpaying.

So it greatly changes the structure of the information, improves the information coming down. Then, as an investor, you should ultimately look to me. I want to be the investor in the other side of this security, because I'm a renter in New York City. I want my kids to have the chance to buy in New York City. I would happily buy bundled New York City real estate that offered enhanced real estate returns. So what you need to do is intermediate simple games in trade. So it's very very past tense as in the Harvard style.

**Douglas Elmendorf:** Thank you. I've had a chance to ask a few questions. Now it's your chance. If you would put your hands up, we'll get a microphone to you. Please begin by telling us your name and any relevant affiliations that you have.

One right here off the middle aisle.

**Question:** Jennifer Curselake with the Federal Reserve. My question is for Michael. In terms of the smart defaults that you just mentioned just at the end, how do you square that with fair lending concerns?

**Michael Barr:** We don't really fully develop that idea in the paper. We know that fair lending papers might arise in the structure of the smart default.

And we'd need to work it through. But I do think it's an important issue you raise. We need to think about whether smart defaults can be constructed that are sufficiently disassociated from prohibited characteristics that these issues wouldn't arise. But it is an important question.

**Douglas Elmendorf:** In the back over here.

**Question:** Good morning. My name is Hirshel Labeaux. We used to call this underwriting. What happened to the question of suitability? Where does FHA and private mortgage insurance fit in? If we're going to reduce risk, why do we have to go to new products, why don't we use the old ones?

**Michael Barr:** Let me take a stab, and you can go in as well. There are lots of ways to get at the problems that we had in the mortgage market in the last 15 years. But I think it's important to recognize that the incentives that created the craziness that we're in now don't disappear under anyone's system. That is to say, it's very difficult to drive agency costs down to zero in any private market. There's always going to be a wedge between the incentives facing different participants in the system. I'd rather not base the system on those costs being zero. So our strategy is to say let's start with a clean, easy-to-understand mortgage product that's going to work for most people and use that as the benchmark, the status, the expectation, the anchoring for all the kinds of products we offer in the system.

**Douglas Elmendorf:** Andrew, do you want to respond also?

**Andrew Caplin**: If we stick with the existing mortgages we'll repeat the past cycle. Basically what happens is, it's easy to make a loan 70 percent loan-to-value ratio, if somebody brought in 30 percent, that's wonderful. Then you get the ownership rate tanking. Then you get people complaining that there's a big problem, which there would be. Then you have to start edging towards riskier products and in all those products, these are the ultimate solutions. The products that came were totally natural results of the restriction to all debt. If you keep the restriction to all debt, you will repeat the cycle.

**Douglas Elmendorf:** Thank you. Other questions?

**Question:** [Inaudible] from The National Association of Realtors. The share of appreciation mortgage, now does the homeowner have an incentive to build value the old-fashioned way, remodeling, sweat equity, or would the share appreciation be based upon some failed price index type, where it is mortgage-driven and not individual property-driven?

**Andrew Caplin:** The indices as yet are unreliable. So it can't be done that way. Actually, no one understands the property of indices. So you can't use them. You have to use the individual house. Inside the individual house, there would be a contract. The contract would say for large adjustments there's an adjustment in the basis. For small, you're on the usual, which is I mean [Inaudible] so you can't let the thing deteriorate but for major adjustments, when you make them, there's an increase in bases. So basically, yes, you benefit from major changes you make.

**Douglas Elmendorf:** Question on the end.

**Question:** I'm just wondering how you deal with the realities that we have this bifurcated mortgage market with one heavily regulated and heavily examined piece. But you could argue offered a default mortgage, whether it be FHA or a conventional mortgage that the market ran away from to the unregulated, unexamined side. So it feels a lot like you're recommending constraining both FHA and insured depository mortgage lenders so that we get to reinvent the whole crisis that resulted from unregulated/unexamined.

**Michael Barr:** Thank you, Judy, just to clarify, so we're talking about a product that, a system that applies to all players. All institutions in the system, all seekers of mortgages.

So we're not -- we're decidedly not trying to pursue a strategy that applies to insured depositories and not mortgage lenders, independent brokers and the like. It's uniform regulation for precisely the reason that you mentioned and that Ned Gramlich was talking about for years before his untimely death, we had this giant supervisory hole in the safety net. And I think that it would be crazy to repeat that mistake going forward.

**Douglas Elmendorf:** Other questions? Here in the back and we'll take one more.

**Question:** Scott Winship, with the [Inaudible] Trusts Economic Mobility Project. My question is for Professor Caplin. I was wondering whether you thought about the potential for shared appreciation mortgages to have an effect on some of the community development issues that were discussed in the last panel? You can imagine all sorts of incentives for lenders and investors and securitized products to get more interested in the quality of neighborhoods as a whole, to the extent that affects the housing prices they've got a stake in, even things neighborhood schools. I don't know if there's sort of another aspect to all of this that might be explored?

**Andrew Caplin:** Personally, I do think there would be a large political economy effect in the medium term if you could get this type of mortgage to take off. Because basically you'd have a lot of more stakeholders in the quality of the neighborhood. And those stakeholders would object a little bit because you've just decided to put a dump somewhere. Well, guess what, it's not just the individual homeowners, but there's somebody who will gather the homeowner's association because they're, in essence, a co-owner.

**Michael Barr:** We'd never put a dump anywhere again. (Laughter).

**Question:** Bart Harvey. Professor Caplin, have you done any modeling? We modeled the share appreciation mortgage -- we think it was very interesting idea for workforce housing -- over the last couple of years before the crash in the housing prices and couldn't find investors to take the risk at the kind of yields that they would get even -- I mean this is before housing started to decline.

I just wondered if you had -- because they're taking a long-term risk on this. They're not quite sure what they're going to get at the end. If you look at former prices of housing through indexes around, nationally around the country, your returns weren't high enough for the risk involved. I just wondered if you had looked at that and modeled that differently.

**Andrew Caplin:** Yeah, we've looked at it a lot. I mean basically we've done a huge amount of modeling of the types of returns that you could get and how you'd have to enhance real estate returns to make it attractive to people. Now, what I would say is right now that story wouldn't sell anywhere. You could not -- but what would sell is that we have a bunch of these mortgages already written. So the first, the way you begin the market is you take the mortgages already written, renegotiate them to be higher value mortgages.

You then get the cottage industry going that basically learns how to value houses better and learns how to build conduits, because it's a very complex infrastructure.

You need to build a conduit for me the ultimate investor who I would invest in the securities. You need to build a conduit for me to that, out to the homeowner. Now, that's a lot of building. The good thing is we have a huge opportunity right now as we start building.

By the time that's done, you could actually produce prospectuses on well-designed mortgages that would make them work.

**Douglas Elmendorf:** Okay. Thank you very much to Andrew and his colleagues and to Michael and his colleagues.

(Applause)

We will take another short break, and then we'll begin very soon our third panel on current issues in housing financing credit markets. Thank you.

**Greg Ip:** Thank you very much, everybody. This has obviously been an interesting two weeks. I went to work -- I left the Daily Newspaper about two months ago to work for The Weekly, thinking I would have the luxury of relaxing for four, five days, thinking big thoughts, knowing what I'd write about. I find every day my big thoughts are different from the big thoughts I had the day before.

Back in March, a lot of us thought that the crisis in housing and finance, more generally, had bottomed out. And we began to think a lot about what the future architecture of the system would look like. And people, myself included, wrote articles, basically, saying that.

Boy, that was one bad call. It turned out that what started out as a housing crisis has continued to mutate into a broad financial systemic crisis and we've certainly seen it reach some form of a climax, I think, in the last week or two, one hopes.

A lot of people obviously have been caught off side and surprised by this. One person who deserves some credit for superb timing, whether he meant it or not, is Douglas Elmendorf, who scheduled this program a couple months ago. And, Doug, all I can say, when I go and buy my next house, you're my consultant to tell me when to do it as far as timing goes.

I want to keep this a fairly good discussion here, so we have a terrific panel. Larry Summers, I think you all know. Needs no introduction. Eric Mindich from Eton Capital, one of the more thoughtful people I've dealt with in the financial markets. I remember some time ago, Eric and I were having a conversation about this crisis. And he said something that I remembered ever since, which was that the root of this crisis was that there was this widespread assumption that national home prices would never go down, that you would have regional desynchronization perhaps, but you would never get a big national decline in home prices.

What, of course, happened was that the industry and everybody collectively went out and designed products and invested in ways that guarantee you will get a housing bubble and, therefore, national home prices would go down. And I think that at the root this is kind of what brought about this crisis we're still struggling with. Because it is still a housing crisis, notwithstanding the fact that it's morphed into all these other forms.

Sheila Bair, on my left is the Chairman of the Federal Deposit Insurance Corporation. I've known Sheila for years, in many different forms.

And I only recently realized that all these jobs she's having were really just an excuse to make some money so she could continue her true love to be children's author, including this book *Rock, Brock, And the Savings Shock.* If you haven't read it, I urge you to go ahead and get a copy. Sheila will be signing copies afterwards.

And the center of the story is that a grandfather tried to teach their children about saving. And promises to double whatever money they saved from their pocket money every week.

Well, Sheila, I actually sat down this morning and I worked out what the APY is on that. It's 4.5 quadrillion percent.

(Laughter)

If we had grandfathers like that we wouldn't have a savings problem, housing problem in this country.

**Sheila Bair:** Promotional rate.

**Greg Ip:** Yes. Let me start off the conversation with you, Sheila. There's a lot of business before the agency. You found yourself at the center of a lot of issues. Can you give us a five-minute recap of some of the initiatives that you and the agency are working on?

**Sheila Bair:** Well, I hardly know where to start. We've actually, if I can sound maybe a little bit smug to begin with, I think actually the banking sector is holding up pretty well. We clearly have got some challenges, but at the end of the second quarter, 98 percent of the banks were well capitalized, representing 99 percent of all bank assets.

We had about 117 banks on our trouble bank list. That's very low supervisory rate and representing only about [Inaudible] of assets. So that number is going to go up. Banks are increasingly facing challenges. And as the credit crisis morphed into more fundamental economic problems, and we'll see more traditional credit distress, that's going to challenge banks any further, but even further.

But I think it's worth noting that banks so far are faring pretty well. And a lot of the troubles we're seeing in the high priced, high profile assistance that has been required has been for non-banks. It's not been for insured depository institutions.

So I do think that it underscores somewhat one of the lessons learned on this going forward, is there's some virtue to regulation, virtue to leverage constraints, things like the leverage ratio and strong risk-based capital standards, what the FDIC has long fought for.

I think those are serving the banking industry well. It's not to say we don't have challenges. We do. But, overall, it's one of the reasons why insured depository institutions are in relatively stronger condition than other parts of the financial services sector.

We, of course, also express -- started expressing concerns about the housing market quite some time ago and called early on for restructuring systematic widespread restructuring of a lot of unaffordable loans that had been originated. And that was in excess of that, and I think we still plug away at it. Now that we're conservative for any amount, we have a chance to develop our own model which I think is going along quite nicely. And I think we'll talk more about the Treasury plan and I think the Treasury plan will also offer some opportunities to get a widespread restructuring of some of the these unaffordable loans.

But the cause of our economic distress continues to be driven by housing. And I continue to think if you track the core of the problem it's by restructuring these mortgages. And so we're hopeful as Congress moves forward with the Treasury plan, that this is going to be the purchase and restructuring of home loans or perhaps some type of guarantee program will be a feature of that.

We have about 45 billion in our deposit insurance fund right now. There's a lot of focus on that. That's our industry funded reserve. We think that that will be ample to meet leaving the high loss of scenarios, the internal stress we do in terms of bank failures that might be coming our way.

We are going to be raising premiums in early October. Not shockingly so, but significantly, so shall I say. We do think it's important to continue to rely on unindustry funded reserves to cover, certainly cover our losses and hopefully meet all of our working capital needs as well. There has been some confusion and some misunderstanding of what the industry funded reserve is. It's just that an industry funded reserve. It is not the only resource we have to fall back upon.

We are a government agency. We are exclusively backed by the full faith and credit United States Government. We have long-standing lines of Treasury, wide flexibility to borrow from Treasury if need be to fulfill our guarantee. Though I don't think that's going to happen.

And I think Hank's got enough other people knocking on his door. I'm trying very hard not to knock on his door as well. We're going to try to do it. And I'm sure the banks will be very happy. In October 1st when we put our proposal out for increasing premiums, but I think it will be at a level that the industry can absorb.

Again, there's a lot of excess capital in the banking industry. And we want to keep it that way. We think things like Section 23-A that inhibit the ability of affiliates to use insured deposits for higher risk activity outside the bank is important to continue stringent enforcement of that. Obviously maintaining our leverage ratio.

With all the problems with the various risk-based capital systems out there right now, I think our leverage ratio has, again, been an important constraint. And it's helped keep banks healthy.

I think, overall, the deposit insurance fund is strong. The FDIC is strong. And the banking industry overall is strong. Though there were clearly individuals institutions with challenges, and we'll deal with those as they come our way.

**Greg Ip:** Obviously the big news, the big elephant in the room as it were, is the Paulson plan, the $700 billion fund to purchase damaged assets out there. It's been sold, or it's been described as an attempt to get at the root cause of the problem. So I would like the panelists to address the question: Do you think this will get at the root cause of the problem? Will it bring the curtain down on the crisis, set the way forward out of this mess?

And in what risks do you think that the policymakers designing this must be especially aware of as they go about designing and executing this plan?

I'd like to start with you, Eric.

**Eric Mindich:** Thank you. Thanks for having me here. So as far as the Paulson plan is concerned, I certainly think it's very important and constructive step. I think that without it, the financial markets last week were on the verge of some very unattractive potential outcomes. And I think that in many ways the bad assets and the lack of clarity around the valuation, markets' view of the valuation of those assets and the ability to recycle that into fresh loans was, I think it was kind of very important to that.

And so I think that it has a lot to recommend. I think one important thing that hasn't been discussed as much in terms of getting to the root cause is that banks were obviously very important lenders in our economy, but the capital markets were also very important lenders in our economy.

While this does a reasonable amount to help free up and unstick some things in the banking sector, it really doesn't do anything to help unstick things in the capital markets.

In fact, if anything, by having such a large government role to own these assets as opposed to fostering private capital to buy those assets, in some ways it takes us further away from getting an active capital market and securetization solution to that. And I think that needs to be borne in mind. Obviously first things first, and second things second.

But I think it's important to keep your eye on both the regulated financial sector as well as the capital markets as providers of credit in our economy.

**Greg Ip:** How would you tweak the plan to address that shortcoming?

**Eric Mindich:** Few suggestions on that. Let me first say it's important in these things not to have the perfect PDM, kind of do what you can do. I'd say there's probably three things I might suggest.

I'd say the first one has to do with -- I guess there's still confusion, lack of clarity, maybe, to me, about whether the objective of this plan is to buy assets at the lowest price of the taxpayer they can possibly be purchased, or whether it's intended to be some type of opaque subsidy to the banking system by buying assets that are priced that might be above the price that right now an incomplete market might discover.

I think it would be very important for us to have a sense which direction that was. I'm assuming for the moment that the objective would be to buy those assets at the lowest price for the taxpayer. And that's [Inaudible]. If that were the direction, there's obviously been a lot of talk about these reverse auctions. I'd say those are enormously difficult to do. Frankly, I haven't been able to see how one would actually execute on that. Because these assets are so heterogenous. There are thousands or hundreds of thousands of line items, even if you had identical underlying assets, the cash flow waterfalls in the securities can make enormous differences, when the private market buys these assets, they tend to be the product of weeks of negotiations and further due diligence and all sorts of things to make it not as susceptible to a reverse auction. One very simple thing you could do would be to say that when the government purchases any assets, that 10 percent, that the government can only purchase assets if a private buyer bought 10 percent of that transaction at the same time, for example.

If you did that, it would ensure that there was some real money third-party buyer that had validated that price as opposed to just the asset manager for it. It would have the second virtue of kind of getting the private markets, kind of the private sector engaged in this process and maybe the private sector would find they liked it and they would put up some money and that would be a constructive thing.  So it's kind of one thing I might suggest on that.

I would say a second thing along the lines of getting the capital movements moving, more significant departure from what's been happening.  Is that the part that's missing in the kind of purchasing of these assets aren't people willing to take equity risk on these types of assets, but it's the ability to buy the entire loan.

So if you were to divide up the ability to buy a loan into the equity risk and kind of the more kind of triple A part of that loan, that's really the part that's been missing.  That's the part that's been gone because of what's happened with the asset backed commercial paper.  And the capital markets saw these things.

So instead of having the government buy all loans, kind of buy 100 percent of loans, what they could do would be to create a program where they would loan money to banks or other private sector participants who could buy those assets.  That loan could be a, it could be at a very high interest rate, 200 over LIBOR, 300 over LIBOR, some very high rate.

And that loan could be, could have to be deemed to be triple A by both a rating agency and even by the Congressional Budget Office or some more objective entity.

And the private sector could be in the first loss position, and the government could essentially get, either guarantee loans at a 75 percent loan-to-value rate or 50 percent or some number like that.

If you did that, it would serve a few advantages.  Number one, obviously it would, the government would be in a more protected position.  Number two, it would take the government out of the business of negotiating, kind of putting these counterparties, private sector people who are more, generally more experienced in that, into that position.  So they would really kind of get true price discovery from that.

And, third, it would bring in private capital, either from overseas or from institutions in other countries so the taxpayer wouldn't be bearing 100 percent of the burden, but other people would be doing that as well.  And if it wound up taking off, maybe the government wouldn't have to buy very many things at all, and it may help to get the capital markets moving.  Those are a suggestions.

**Greg Ip:**  Sheila, why don't you address that.  I'd like to hear your views on the merits of going the approach of purchasing the assets versus putting capital directly into the weakened institution.

**Sheila Bair:**  Well, I think you probably need a combination of approaches.  But we think, again, you've got about 250 billion of delinquent private label mortgages.  And you've got about two trillion of mortgage-backed securities and CDOs.  So if you're trying to tackle the securities and get those illiquid assets off bank balance sheets, it's presumably going to be a lot more money than trying to deal with the 250 billion of distressed mortgages that are creating the uncertainty and distress with the structured finance products upon which the mortgages are based.

So there is some immediate need for liquidity. So I think you do need a combination of strategies. We would hope, and I think the bill will reflect this, that there is a whole loan component to this.

And I think if you do it either through acquiring the assets or perhaps some type of guarantee program, you know the GSE and BS markets are still reasonably liquid, especially now that the GSE are on under government conservatorship.

Perhaps you could provide some type of guarantee program for delinquent loans, conditioned on some effort being made to restructure those responsibly. If they still don't perform and the government would be willing to come in and buy them and move them out of the pool.

But that kind of, that might provide some stability for the underlying private label mortgage assets in a way that would benefit the values of the MBS and CDOs as opposed to just having a strategy primarily focused on buying the MBS and CDOs, move them off of bank balance sheets or other financial institutions' balance sheets.

**Greg Ip:** Larry, I'd like your thoughts on this. I'd like you to spin it forward and address the question, is this the turning point or how much -- how much further do you think we have to go in this combination housing and financial crisis? And should we perhaps have some more hope that we are at a turning point and whether this program, in whatever form it finally takes, will get us to that turning point.

**Lawrence Summers:** On your actually question I'll borrow from JP Morgan and make only the prediction with respect to the markets that they will fluctuate.

(Laughter)

But I do want to say a couple of things about the broader situation. We saw something last Wednesday and Thursday that I thought I would never see in my lifetime as an economist.

The Treasury interest rate going out six months was negative. That is, people paid the government to store their money for them because the mattress didn't really work very well and because they didn't trust any other place in the private market to do it.

And that is a mark of the trauma in this situation. And while there has been some repair in the last three days, it would be a grave mistake to suppose that we are out of the woods.

In that context, there is far more risk that the authorities will have too little flexibility to enable them to respond creatively to keep the financial system going than there is risk that they will have too much authority with respect to the financial system.

I think, though, that there's a lot of talk of what's the root cause and what's the silver bullet? And this problem has in common with most problems, most problems that are actually worth having panels like this about, that they don't have a single root cause and are not amenable to a single solution.

I'm inclined to think of the current situation as a concatenation of four separatable type of problems, each of which demand a response. The first is the prospect of a mass rush for liquidity. That's what we saw last week. That's what drove the interest rate to Treasury Bill interest rate to being negative. That's why it was necessary to take the extraordinary step of the government insuring all money market fund accounts. And preserving the basic --

**Sheila Bair:** Only as of Friday.

**Lawrence Summers**: As of Friday.

**Sheila Bair:** Don't take the process out of the bank, please. (Laughter).

**Lawrence Summers:** The basic protection of the health of the financial system and the prevention of a systematic collapse is the first imperative of policy.

The second imperative of policy is that you have a substantial, perhaps have -- I'm inclined to think you do -- a substantial volume of securities which, for a variety of reasons, do not now have well-functioning viable markets.

And who the absence of which acts as a major inhibitor to financial activity of all kinds. It acts as an inhibitor to recognizing problems where they exist. I think one place where I am less serene than Sheila is with respect to the banking system's relative performance.

One interpretation is that the banking system is doing better. The other interpretation is that the banking system is less quick to recognize its problems because of a variety of accounting issues. And I think there's some element of both.

So a second major problem is responding to these distressed and beaten down markets and there the notion of government purchases of securities on a substantial scale or financing to enable the private sector to do it has a substantial role. That appears to be a central focus of the Paulson plan, and I think that's very important.

Third is the question of the capitalization of financial institutions. On a very optimistic view, and it's conceivable that this very optimistic view is correct, that that would not be my expectation.

If you were able to repair the market for securities, then all these assets would rise in value. And after all the assets had risen in value, there would be only isolated capital adequacy problems in institutions of a kind that Sheila could take care of through her regular means.

That's possible. I think the substantially greater likelihood is that whatever you do to contain problems one and two we will have a substantial capital shortage in the financial interest mediation sector for quite some time in the United States. And an important priority for public policy will be doing something about that.

How government does that without either providing corporate welfare on the one hand or on the other hand acting in ways that inhibit any presence of private capital is a very complicated question.  But it seems to me one that needs to be addressed going forward and one that is in the context of, that the authorities that Secretary Paulson has requested would enable the government to address.

I personally am skeptical of the idea that's put forward by some that assets should be purchased at par value or at current marks, where those don't reflect a private market value in order to help make banks in a stronger situation.

It's indeed true that if you purchase things at par that are selling for 50, the institution you did it for will be glad you did and will have more capital after -- we'll have more capital after you did it than they did before.  But that doesn't seem to me to be a, to constitute a well-designed policy much of the time.

The fourth problem, and I don't believe we will have a healthy economy unless we address the fourth problem, even if we were brilliant with respect to the first three, is something that Sheila touched on, which is the difficulty in the housing sector, the consumer balance sheet and the nexus of the consumer with housing.

One thing we are learning throughout this is that there are enormous frictions associated with financial failure.  You see it from the tremendous losses that followed what happened at Lehman.  But the same thing happens at the level of the individual household.

The estimates differ, but probably well over half the value of a house is lost when it is foreclosed.  And if one added in the loss in value to the neighboring houses, it is very likely that the total value of the house is lost when it is foreclosed.

Where there are mutually beneficial deals in which renegotiation, short sale, mortgage reduction enables the person who should live in the house, who actually has the highest valuation of the house, the person who's now living in it to continue there, there are enormous efficiencies that result.

So I think it would be -- it is incumbent on us to maximize the pressure for such renegotiation and write down.  It's a complicated subject, because there are a lot of people who have negative equity, who are currently paying their mortgage.  And the world is moving along fine.  And if you make it too easy for anyone who has negative equity to renegotiate their mortgage, they all will, and then you'll exacerbate the problems in the financial sector.

So it is not a simple issue, but I'm convinced we could be doing substantially more.  And that by doing it we would maintain the demand in the economy more satisfactorily which feeds back on all the other problems, as well as doing right by a large number of other families.

**Greg Ip:**  It was interesting, we had a bit of a disagreement I guess on the health of the banking system.  But I think one of the things you can see going on now is that what was called the shadow banking system, all the finance companies, the investment banks, the off balance sheet vehicles which finance so much of the leverage in the last 10 years, have basically folding in upon itself and they're either being, either going bankrupt like the old stand-alone mono line mortgage companies, or they're selling themselves to banks, as Merrill Lynch and Countrywide did, or they're becoming banks, as Morgan Stanley and Goldman Sachs have now said they plan to do.

And so that raises an interesting question. Are we going back to a purely or almost purely bank-based financial system? Is that a good thing? And given the federal commitment to back-stopping that system, are we in for -- what are the implications for public policy both in terms of regulation and taxpayer liability.

Sheila, do you want to tackle that?

**Sheila Bair:** I don't think it's necessarily a bad thing. I think banks have some advantages right now, which is one of the reasons why you are seeing and welcome debate whether the accounting, somewhat different accounting rules for banks is a good thing or bad thing, with the advent of fair value accounting, the ability to say a lot of these marketing evaluations are deep discounts to actual cash flows. So I don't know if that's a robust debate going on in the accounting industry, whether that's a good thing or not in terms of banks realizing real embedded losses.

But deposit funding, obviously, is a very important and stable, and we're working very hard to keep it as a stable source of funding as the secondary markets have dried up. Deposit funding is providing a source of credit for lending activities, supporting economic activity. And that's very important.

The FDIC insurance, obviously, provides that that funding remains relatively stable. And we're working very hard. We've launched public service announcements. We already had a public education campaign going in conjunction with the 75th anniversary to make sure people are reassured about the safety of their insured deposits.

I think banks being more regulated right now, I think that underscores some of the strengths of regulation. We don't need a lot of regulation. We don't need prescriptive regulation. We need some basic standards, as well as consumer protection. And banks, again, are far from perfect. Many banks do have problems. And banks do engage in some of this lending that should not have occurred.

But, overall, it's a more heavily regulated venue. And also I think the arbitrage between the more regulated banks and the non-bank lenders kind of helped feed the securitization of lending standards, whereas the bulk of the activity is being conducted in a regulated venue. I think you do have some floor against hopefully this not starting up again when some crises stabilize.

So I think it is the direction that markets are going. And I think that the reason it is, is because banks have strength with deposit funding and stronger capital standards; and, again, I can't overemphasize the importance that we ascribe to strong capital standards, hard and fast leverage ratio, as well as restricted 23-A type restrictions that are imposed upon depository institutions to make sure, to the extent there's more highly leverage, less regulated affiliates are out there, that they did not access the deposit insurance with the federal government's ultimate guarantee to fund higher risk activity.

So it is what it is. But I think that the good news is that it is there. The banks are still standing. They're lending. They do have a stable funding source. And given the fragility of our economy right now, I think the importance of that can't be underestimated.

**Greg Ip:** Eric, I'd like your thoughts on that, especially hedge funds are part of the shadow banking system, and they've thrived in the environment of like low regulation, so forth. If we're in a situation where that business model is less viable and more of the financial intermediation goes back into a tightly regulated bank system, what are the costs to that?

**Eric Mindich:** Sure. Well, I think that we may -- I would say in terms of the formal kind of direct customer-facing non-bank financials, I think you're right about how that's changed. But I think that there is a very significant amount of money available in the private capital markets for lending. Very significant amount.

In fact, you know, hedge funds and private equity funds are the owners of the leveraged loans that were done from the LBOs that wound up being sold from the banks into the market that way. It's going to require different funding structure than what had been done before.

But there's enormous amount of capital available to do that. It tends to be the higher priced than what banks might have lent at before, in part because of the higher return expectations that private capital investors might have. And in part because they have almost always generally operated on a far lower leverage ratios than banks do. In part because their equity is not permanent but is of limited life or withdrawable.

But because of that there's a significant amount of capital there. There are some things that actually could be changed to make even more of that available at a time when we're in this problem. So right now there are a variety of tax issues associated with offshore money, essentially being in that business of originating loans.

One very easy way to kind of increase the capital available there would be by making some changes there or by changing some of the Safe Harbor definitions, even for domestic monies, to be in the active trader business of doing that.

You could put up a number that would make it clear that you weren't acting as a bank but engaging in a limited number of transactions, and that would put a lot of equity capital in that would help the system. I think we'll see, whether we have that regulatory change or not, I think we're going to see more and more capital coming into that market as the price, as availability's restricted and price the higher.

**Lawrence Summers:** Sheila, what's the total volume of insured deposits?

**Sheila Bair:** About 4.4 trillion.

**Lawrence Summers:** What's the total of deposits in all banks?

**Sheila Bair:** Domestic, about 7 trillion.

**Lawrence Summers:** The hedge fund in private equity industry together is well over 2 trillion. Money market funds are 3.5 trillion.

Direct pension investments in equities and the rest are in the 5 to 8, in the 5 to 8 trillion dollar roof. So I think it's important to understand that it's not very likely that the majority of financial activity in the United States is going to be coming running through banks.

And if it somehow were, the size of the implicit liability to the federal government would become very substantially greater than it is. And then most of the money that's in the shadow banking system is accounts that are greater than $100,000. And if it moved to the banking system, it wouldn't have the kind of automatic stability that deposit insurance has.

So I share the sense that we're going to become a more bank-centric system over the next five years or the next decade than we were over the last.

But I think to suppose that we're going to go back to the world of 1965 or the world of many other countries where the preponderance of financial activity was taking place through banks is probably not a realistic prospect, and that means that we're going to have some very difficult questions to judge about the regulation of the shadow banking system. It's enormously tempting to say regulate everything upwards, more capital charges on everything. But there will be a strong tendency for any activity that is regulated heavily to lose share relative to activities that don't.

And one of the reasons why you saw the huge growth in off balance sheet activity was precisely because it was disproportionately unregulated relative to on balance sheet activity.

So I don't have the answers, but I think the questions are really very difficult, and we're not going to -- we're not going to be able to avoid thinking very hard about the structure of a non-bank financial system in the United States.

**Sheila Bair:** I do think that's next year's issue. We've totally got to rethink the structure for the entire system, not just for banks. But I would say now, for banks, at least you have a process. And, yes, there's a federal, ultimately federally backstop. So far all losses have been covered through an industry funded reserve, not through the taxpayer.

And we also have a process. We have PCA. We have regulations. We have a process for closing a bank. We have a process for equity shareholders and certain creditors to take care cuts before we would take a loss and ultimately exposing the taxpayer.

So there's a process there. In contrast to the non-banks that have been getting nice checks, right, from the government, either through loans or direct assistance. And two and a half in trillion money market funds now getting a federal guarantee, never paid a penny of premiums unlike our banks.

(Laughter)

Expanding the federal safety net, the federal safety net is expanded. Expanded to those who never were supposed to have it. There was no statute that said you're backed by the full, faith and credit of the United States government.  There was never supposed to be the expectation.  Never supposed to be the situation where the government should have had to do this.  But because of their size and systemic importance, it happened.

So I think going forward, perhaps an explicit federal backing under certain conditions, we should expand it in a way that requires the benefiting from that federal backing to pay up front just the way banks have had to do, and defines who is going to get it, who is not going to get it and under what terms and conditions.

**Greg Ip:**  Wanted to respond to one thing Larry said about most of this money going will be over the 100,000 cap.  I saw an ad in the Washington Post recently for a very small bank in Northern Virginia, advertising up$50 million of FDIC coverage.  So I'm not quite as sanguine as you that it will all be outside the deposit cap.

Also the shadow banking system and all the wonder it's gotten a bad rap lately, but we should think back that a lot of the stuff we were praising just a few years ago like sub-prime loans which were bringing home ownership to a lot of people at no cost to taxpayer, excellente, and the whole mortgage backed security markets and many ways, the liquidity of that market were products of the shadow banking system.

And we shouldn't sort of lose sight of the fact that losing those things could, at the margin, result in less innovation and pure financial products that I think are good for customers.

But we've sort of moved into this area of regulation which I think is very interesting.  And there's been a lot of debate recently, especially about the wisdom of Gramm-Leach-Bliley, which basically broke down the remaining walls between insurance, securities underwriting and banking.  And I'd like the panelists' view on whether that, in retrospect, was a good or a bad thing.

I would also like to go back further because a lot of people forget that in the last banking crisis, the S&L crises in the late '80s and early '90s, we also underwent a major regulatory reform, FDICIA and FIRREA, and that gave us prompt corrective action and least cost resolution.

I'll start with you, Sheila, especially.  Do you think that with the benefit of hindsight that those have worked well and that they can be a model for moving forward as we expand the safety net?

**Sheila Bair:**  I do think they've worked fairly well.  There are a couple of issues where we think, going forward, we might want to make some adjustments.  This one, PC is heavily driven by capital solvency.  It's a solvency determination, prompt corrective action.

**Greg Ip:**  Go in close a bank.

**Sheila Bair:**  Yes.  As a bank's capital ratios get further and further down, there are required supervisory actions, increasingly more aggressive supervisory actions to take to try to correct the situation with the bank.

There's this same issue, there were institutions that were not viable, that they were at some point going to become capital insolvent. But it was really a liquidity situation that triggered the need to close them. So I think maybe trying to build some liquidity triggers into these formal mechanisms, something longer term, is something we need to look at.

Also, we have found that we have offsite monitoring systems and we try to -- we can't regulate everybody. We are the primary regulator of 5200 state chartered nonmember banks. And obviously we're the back-up supervisor insurer of everybody. For those that we're not the primary regulator. We have off-site monitoring systems, but those really don't kick in until the bank starts to get into trouble.

But I would like a mechanism, and this is something, again, I think this is next year's issue because it would need to be something carefully thought through, but maybe the ability to force a sale on an open bank business.

Because now pretty much we can't get involved until the bank gets to the point where it needs to be closed. Frankly, I think we could minimize our costs. It would be pursuant, consistent with lease costs, if we had more authority to facilitate solutions on an open bank basis.

Those are kind of two areas that I think longer term we might want to look at and work with Congress to adjust PCA. But, overall, I think it's working quite well. And I think the lack of discretion, if you will, when you hit these triggers, to take action has been important. So I think FDICIA has overall service very well.

**Greg Ip:** Eric, I'd like your thoughts on where we need to go with respect to regulation and what worked and what didn't from what we have.

**Eric Mindich:** Sure. I'll make two comments. One is that I think it's important we regulate based on the activities of organizations as opposed to on their legal form. Obviously that's one of the issues. We certainly learned that a lot of insurance looks a lot more like mortgage banking than people had appreciated before and a number of other things like that. I also think that someone who can take a look at the entire entity in terms of how it is, I think we all see why that's important.

One thing that I've mentioned, which may be of somewhat less relevance after the news on Morgan Stanley and Goldman, I think one of the big problems was that there was no mechanism to seize a broker/dealer or seize one of the prime brokerage business of a big securities firm in the same way that you can with a bank.

So, for example, folks who are prime brokers, clients of Bear, Bear Stearns, and Bear Stearns was relying on their financing, since there was no mechanism to ensure that those deposits would be protected, it basically meant that once there was trouble, people had to kind of run. That's kind of what you saw last week and some of the other things.

So having some mechanism so that if there is a prime broker, it can be essentially closed down as Bear Stearns on a Friday and open up as JP Morgan on a Monday, would give enormously more confidence to the customers of those prime brokerage businesses, and I think that would enhance the stability, maybe even reduce the need for those banks, for those firms to be closed.

**Greg Ip:** Larry, I'd like your thoughts here. And I'd especially like you to sort of cast your mind back to '98 when Gramm-Leach-Bliley passes. You were Treasury Secretary. In retrospect, was it a mistake? Are there ways in which you could have done it differently? What's the legacy of that legislation?

**Lawrence Summers:** I think it was the right thing to do. It was the right thing to do first, because these kinds of combinations were taking place on a ubiquitous basis anyway. And so if one didn't like combinations between banking and investment banking, that had happened 15 years earlier. And it was better for it to be happening within a coherent framework than a completely disorganized way.

I think it was the right thing to do, second, because it seems to me the lesson of this crisis is that promoting some consolidation and combination is substantially stability-enhancing.

Where would we be had Bank of America not been able to buy Merrill because it's illegal? Where did we have the biggest problems in the institutions that didn't consolidate and combine with banks and realize the advantages that Sheila spoke about?

There was an agenda, and we talked about it at the time, of the need for modernizing financial regulation. Bob Rubin also used to say, we need a regulatory system as modern as the markets.

In the context of these ongoing reforms, I think we tried to move that forward to some extent. Frankly, I think after 2001, that effort lapsed pretty substantially, that effort lapsed pretty substantially, and that contributed to where we are now.

But I think it's very -- I think the evidence is that these kinds of combinations are actually healthy, and the challenge is to figure out how to regulate them in the right way.

I would just make one other comment, if I could, on regulation. And it touches on things that Sheila and Eric talked about. You know, there are two basic views as to what you're trying to do in financial regulation, and obviously truth is you need to do both of them.

One, which I would say gets 85 percent of the discussion, but in my view it is only about 35 percent of the importance, is you try to get institutions to not make mistakes that cause them to fail.

Sure, that's a good thing to do. It tends to -- the effort tends to promote a sense of partnership between the regulator and the regulated, which, frankly, makes me a little nervous. And one looks at what happened in the Ball Capital standards, for example; I think I've got some very good reasons for my nervousness. So we can work hard at that and better capital standard and so forth.

I don't think at the end of the day we're ever going to create a world where no institutions fail and where institutions don't fail. And so I think the equally large or rather larger imperative is to do much more to make the system safe for the failure of institutions. Some of that goes to the prompt corrective actions that Sheila talked about. Some of that goes to issues like replacing bilateral exchanges with clearinghouses that have much greater stability properties. Some of that goes to stuff that is mind numbing technical and to most of us not that interesting having to do with procedures for clearance and settlement and the like.

But I would rather -- I would hope that more effort or as much effort would go into making sure that in the next crisis, when you have the equivalent of a Lehman failure, you don't have the kind of mass meltdown that we saw following Lehman's failure. I'd like to see much more effort directed at that question relative to what I think is the slightly shamarical goal of trying to have some regulatory system that will ensure you'll never have another Lehman failure in the future.

**Greg Ip:** But isn't it the nature of these things that every time we try to make a system stronger we're sort of like thinking about the last threat to the system and the nature of innovation and our capital is that activity and innovation and profit-making migrates to the least regulated corner, that's where the next crisis erupts?

**Lawrence Summers:** There's certainly some of that. But that, I guess, is the reason why building a system that is robust with respect to the possibility of institutions failing, strikes me as being a better system -- strikes me as being a necessary component of a strategy because of the critique you just offered that the crisis will always come in a different place, seems to me to imply with rather more force to try to find particular institutions to regulate more heavily and try to stop them from doing whatever it was they did that caused the last crisis.

I mean, let's be clear. There's some lessons -- there's some lessons we learned from the last crisis. We learned the lesson from the S&L crisis period. We learned the lesson that for an individual institution to borrow short and lend long for mortgages was going to be massively unstable.

And that's what kind of led us to securetization. And that was a good idea. But now we've got some problems with securetization. So I think there is a kind of dynamic where you fight the last war, you learn lessons. You adjust. Sometimes you overadjust and we find our way.

But I guess the broad point I want to emphasize here is that -- and I do think there's a pretty -- well, some have certainly recognized it. Sheila has. I think there's a very general problem in the regulatory community, that they focus on the health of individual institutions.

They become identified with the institutions and worry about their problems rather than worrying about the issue I already mentioned, which is the safety, which is making the system failsafe and the different issue of pro-cyclicality, when an individual institution is in trouble, it's good for it to shrink its balance sheet. When everybody tries to shrink their balance sheet at once, it's a catastrophe. If I stand up at a football game, I can see better. If everybody stands up, everybody is less comfortable and nobody can see better. And you have to take a systemic view of it.

And while increasingly in the last month lip service is being paid to that concept, the reality of our structure of financial regulation is that it hasn't really embraced that concept of systemic stability as the dominant paradigm that it employs.

**Greg Ip:** It's been a great conversation. I'd like to get the audience into this. So if you'd like to ask a question, please raise your hand, we'll get you a microphone. State your name and your affiliation.

**Question:** Hi. Ed Andrews from the New York Times. I'd actually like to go back to one of the first questions that Greg raised that I didn't quite hear the answer to, which is to what extent do you believe that the problem right now really is the key problem, the root problem right now is really the stresses on our financial institutions, the illiquid assets that they have in getting them off the balance sheets, or to what extent is it more fundamental in the housing economy, the economy itself? Because there is this school of thought that says we'd be better off pumping money directly into the mortgage market and working it back that way.

**Greg Ip:** Let's each take two minutes to answer that.

**Lawrence Summers:** I'll take less. I think it's a false choice. If you have hypertension, you're way overweight and you're in the process of having a heart attack, what's your most fundamental problem? It's really not that useful to distinguish between them; they're all components of the situation, and you're not going to get to a very satisfactory place unless you address all of them. That's how I think of our financial reality right now.

**Sheila Bair:** I think several months ago we had proposed, actually at another Brookings event, what we called the hop-along, which would be to infuse significant amounts of liquidity. We suggested an initial program of 50 billion that would infused into the system to pay down mortgages. That would be conditioned upon the loans being restructured so they were affordable. So there would be some benefit at the borrower level, but also the payments, obviously, would flow into the portfolio lenders or the securetization investors. So we thought that that was the best way to pump needed liquidity into the system.

I think at this point, I agree with Larry, we need a combination of strategies. We're highly supportive of Treasury's initiative. There's a more immediate need with regard to removing illiquid assets off of balance sheets.

But we think that should be combined with an initiative to tackle the home loans as well, because we will not get out of this, you will not see the light at the end of the tunnel until home prices stabilize. And the key part to getting home prices stabilized is to get these loans restructured, get them affordable, people staying in their homes.

And that's harder to do. And there are streamlined ways to do it. And we're developing some good systematic approaches with Fannie Mac, but I don't see us getting out of this until we stabilize home prices. And that means to get these loans restructured.

**Eric Mindich:** I would add, I go more fundamentally. I think the core root of where we got to was that credit was too easily available and too cheap for too long. That manifests itself throughout all sorts of different loan types and underlying asset types.

It so happens that home prices were the biggest part of that bubble. Home prices, because of the securetization and the residential mortgage backed securities market, they went the highest first and then they crashed soonest, because you have the most observable price.

I think the same underlying phenomenon that we saw in housing we're seeing in auto loans, in credit card loans and student loans, kind of much more broadly. But it's just not as visible, partially because it's been drowned out by all the noise on housing and partially because housing went first.

So I think there's some risk that if we spend all our bullets on housing, there weren't be any bullets left for the other things. Which is not to say we shouldn't be doing what we're doing, but I think we need to be mindful that there will probably be more chapters. We might be in the moment of highest velocity on the downside; therefore, it calls for urgent action. But I think we need to be very mindful that there are further ripple effects we're likely to see.

**Greg Ip:** Personal observation on your question, Ed. I think one of the reasons the authorities adopted the ad hoc approach and they concentrated on liquidity and solvency at this point, they had a fundamental view that given enough time housing prices would return to equilibrium. And we've already seen home construction fall well below sales, and that the system was returning to equilibrium and all that was needed was time for that process to work. But unfortunately the crisis moved on and hit us.

So I know Larry loves medical analogies, so I'll indulge in one, too. When a cancer spreads, you don't necessarily cure the patient just by knocking out the original tumor. And I think that might be one of the ones right now.

I'll take another question here. State your name and affiliation.

**Question:** Hi. I'm Mary Riley with Brooke and Riley. I want to go back to a comment, Eric, you made early on. I want to make sure I understand. Were you suggesting that the Treasury should buy these assets at current value to get the lowest cost to the taxpayer?

**Eric Mindich:** I was suggesting that the Treasury should -- I was suggesting that I think it would be logical for Treasury to buy them at whatever the current market values are, which is not necessarily the current markets on banks' balance sheets.

We'll find out what the right price is but not necessarily the current marks. To the extent there are any holes that are created because of that, the government can do what it wants to help recapitalize those institutions in a more targeted way instead of in a very blanket way.

**Question:** My confusion about that is that isn't that assuming then the problem is really just a liquidity problem now instead of really a value problem? And if we buy them at the current market, that's injecting liquidity into the system. But it's putting the institutions in the same fundamental position that they're in now, which is they'll take significant losses and they won't be any better off than they had been.

**Eric Mindich:** Sure. That's right. There needs to be a -- one needs to make an assessment as to whether one's a believer in mark-to-market and whether that should be an important metric. But if you believe that it is, then it may well be that banks need to raise more equity. And there's the stock market in which they can raise more equity. And those stocks are up a lot since the middle of July, in part because of the government's actions. And there are lots of banks that have got very easy access to the equity markets, maybe not at prices they like, but they have easy access.

And the government, if they wanted to, could provide, perform any other form of commerce they want to shore up who is in trouble. But at least you would kind of call a spade a spade, confront the elephant in the room, and by having more true marks you would restore confidence so people could in fact invest in banks in a more transparent way, know what they were buying.

**Greg Ip:** Larry, you wanted to make a quick comment on that.

**Lawrence Summers:** I think Eric said it. I'm going to say it in a slightly different way. I don't think there's any question that there are serious capital adequacy issues that have to be addressed with policies that are directed at promoting the infusion of equity into financial institutions.

I think there are also issues of liquidity in various markets for which the purchase of assets or the financing of assets is an appropriate response. Many are tempted by the strategy of trying to sort of do both things at once.

An institution's holding an asset at 60, then it's got marked at 60. The asset's really only worth 30. If the government bought it for 55, they reasoned: Wouldn't that be terrific, we'd be kind of liquefying and supporting the market. And we'd also be putting a bunch of equity into the institution and we can all do it in one thing. I understood Eric as being rather skeptical. I think he used the word "opaque," that's not a word you use when you're for something.

(Laughter)

To describe the procedure of trying to do it all in one go. And I would associate myself with the view that you need multiple instruments targeted to multiple objectives. And you need to describe why it is you're using particular instruments towards what particular objective. And the effort to do it all in one kind of go creates opacity that is likely to have a variety of adverse consequences.

**Greg Ip:** Another question here.

**Question:** Michael Barr from the University of Michigan. Chairman Bair, I was interested in your comment about loan restructuring being key. The initial Paulson plan doesn't include any mechanism for doing that. There's been discussion about what it would take to have real loan restructurings in the plan. What do you think the plan should include to make it actually do this thing that you want it to do?

**Sheila Bair:** I think we are -- and I think Treasury is receptive to having a whole loan component to this. There's been discussion with the contractors and FDIC to try to get these loans restructured.

As I said, I think one of the things we are talking about is whether this could be done through Rule 1 acquisitions. Perhaps providing some guarantees under the way GSEs provide a guarantee. But that being eligibility of a guarantee being conditioned upon having a restructuring program so the longer delinquent you restructure it to an affordable debt-to-income ratio, I think that's the metrics to use and the initial outlays are not so great you pay even after that the lenders can't perform.

I do think to the earlier point about the problem of negative equities and the problems that create, with Indy Mac restructurings, we don't focus on negative equity. We focus on affordability. If the loan is at 38 percent debt to income, it's unaffordable and we'll restructure you. But if it's below that, you've got an affordable loan. And it's not.

So I think by focusing on restructuring efforts, focusing on affordability versus negative equity, you get around that problem. And it's not easy. This has to be done. The most important thing is to verify income.

But, again, through a guarantee so you could provide servicers deposit incentives that they don't have now to verify that it can get the loan restructure, see if they can get it reperforming. I think that's one option that it would be nice to have some flexibility either through a guarantee program as well as through direct whole loan purchase, it might be a little more efficient.

**Greg Ip:** Yes.

**Question:** Laura Tyson. I'm affiliated with The Hamilton Project. So my question is a little bit, it's a different kind of question. It really is about the politics. Because I think you've all made it clear that we have several different problems. We have the equity infusion problem. We have the liquidity problem. We have the homeowner loan restructuring problem.

By going up with a three-page proposal, which actually doesn't make those distinctions at all, just cause chaos among the democrats who are trying now to say, gee, well, there actually should be a home ownership part. There should be a preferred equity position part, which they're getting at the kind of equity ownership thing.

And, okay, we kind of understand that we've got to get the liquidity part. But I guess my question is why not from the very beginning say that we have a multi-part problem, which actually describes much more effectively to the voter that homeowners are involved, that the government is going to have an equity position in these institutions? I actually am just staggered by the politics of the way this is being done.

Because it's causing -- it's made it more difficult, it seems to me. I think it will ultimately go through in some form. But I guess I would like your insight into how come we didn't, from the very beginning, make it clear that there are all these parts. Is it more money? Is it -- how much more money do we need for the homeowner restructuring part? If it's a trillion, is that what is keeping them from saying it? I'd just be interested in your views. It seems so staggering. We in this room kind of understand it's different things.

**Greg Ip:** Your question is have we artificially like imposed narrow definitions on what the problem is when we should be allowing a much broader --

**Question:** The Treasury went to the Congress with a huge amount of money without clarification about the various parts. And basically, interestingly enough, they're beginning to sort of piece it apart. But I don't know why one wouldn't do it from the beginning. So it's a little unfair because it's a political question. But if anybody has any insight, it would be useful.

**Greg Ip:** You're sympathetic to this position, I think, but what do you think?

**Lawrence Summers:** It's a political question about the political decisions of actors other than those who are sitting right here. So it's very hard -- so I think it's very hard to answer. I would only say that while it is easy, not easy, but it's relatively easy to sit here on a panel and describe that the problems take four forms or three forms, or five forms, and these two instruments in the way that we all have, that if we all had to do it last month and we all had to do it next month, we would have somewhat different ways of breaking these things down and somewhat different ways of describing them.

It's a rapidly evolving situation. So I understand the impulse to flexibility and to not providing details and precise structure that one may not want to live with in the very different world that may present itself six weeks from now. And that's why I think some articulation of principles surrounding this is something that is very important.

**Greg Ip:** We're up against the end of our time. I would actually like to finish this by asking one last question and quickly getting a brief response from each of the panelists. It seems because this conference has been about the future of housing finance, one of the important questions I would like to address is that we as a society seem to take it for granted that everybody should and ought to own their own home.

But did we kind of overdo it? I mean, the economy and our financial system was riddled through with preferences for housing whether it's like government guarantee through VA and FHA, whether it's deposit insurance for banks that are putting mortgages on their books, whether it was interest deductibility, et cetera, et cetera, and we've just doubled down on that, you know, federal guarantees for Fannie and Freddie and now with this thing.

I'd like to put the question out there, is one of the things that got us into this problem was an excessive, was a financial and tax system excessively oriented home ownership, how should we address this question going forward?

Eric, I'd like to start with you.

**Eric Mindich:** I think that the tax system, I think legitimately favors increasing home ownership. But we didn't change that tax system. So we wouldn't have -- if we changed it, it might have been unfair. I think it's fair for our society to say that home ownership is an important value that we should foster and encourage it. I think we have. I think what's happened is like in many times people learn lessons from the prior cycle. They overlearn them and they make mistakes. I think what you said earlier was right.

Embedded belief that national home prices could never go down led people to design products that ensured that national home prices would go down. And I think that was -- I think that's essentially what happened. I don't think it was necessarily an error on the government side. And I think it's a very important goal that maybe we overshot so we'll have to undershoot for some period of time.

**Sheila Bair:** Right. I think we should continue to support home ownership. I think done the right way home ownership, or a lot of academic literature, it's stabilizing. It's wealth accumulation, it's by far the biggest asset and a vehicle for wealth accumulation for low and moderate income folks.

So there's good policies reasons to continue to support home ownership with responsible lending mortgage products. And we had a conference on LMI and mortgage lending at the FDIC in June and had some wonderful ideas, Michael was there and others, about how to do it the right way. There's nothing wrong with a 30-year fixed year mortgage.

Delinquency rates for 30-year fixed and sub-prime is 9 percent. That's about 27 percent for adjustable rates. Those mortgages aren't really performing that badly so even with this increased distress. So I think there are right ways to do it. But we didn't -- the regulatory arbitrage that was going on between bank and non-bank lenders, and nobody was holding onto the risk. I think that was a key problem that we lost that underwriting discipline from the old model where the risk was held on bank balance sheet.

There was an economic discipline on the lender to make sure that the borrower could repay the loan over the longer term. We lost that with securetization. And when the securetization markets come back, and I hope they will, and I want them to, but we need to address this problem of requiring that the lender, the originator, retain some risk and have some continued economic interest in the long-term performance of the mortgage.

**Greg Ip:** Larry.

**Lawrence Summers:** Yours is a complicated question, Greg. I've got the scars for having had the conviction for a decade that the GSEs were an accident waiting to happen. So their lack of capital was certainly a contributor. And the things they did to promote the sub-prime market were certainly contributors to all of this. But in the main, I think I'm inclined to agree with Eric and reminded of a famous debate among economists in the 1960s.

There were some economists who said that the monopoly was an important cause of inflation, and there were other economists, the ones who ultimately won the argument, who said maybe monopoly caused high prices, but there was no obvious reason why monopoly should cause rising prices.

So, yes, through the tax code and other ways, we have a public policy bias towards home ownership. I think having that bias can be defended. Whether we've got it to the right or wrong extent is an interesting and important debate.

But I don't think, except insofar as that bias has increased, which I don't think it has, that it's right to lay this broad financial problem at the doorstep of those policies. And I also think something Eric said is important to remember.

Given everything that's happening in the U.S. macro economy, in the global economy where you have trillions of dollars of surpluses abroad that were seeking a place to go, if the sub-prime mortgage had never been invented and nothing else had been changed, the United States would still have had bubbles, overleveraging, the bursting of bubbles, deleveraging, and severe and very severe financial problems.

Maybe it would have started in the summer of 2008 rather than the summer of 2007. Maybe it would have taken a different form. But I think it's important to remember that saying that sub-prime caused this is like saying that it was the assassination in Sarajevo that caused World War I. At one level it's true, but at another level it was the particular thing that what proved to be the manifestation of a set of growing underlying causes.

**Greg Ip:** On that word, yes, the World War I analogy certainly put things in context.

Bob Rubin, I'd like to thank the panelists. I know I learned a lot. Now Bob is going to say a few.

**Robert Rubin:** No, actually, I'm not. I was going to thank people for coming and saying that, I was going to say, and it was, the panels were absolutely terrific. And now that The Hamilton Project solved this problem, we'll decide what to do next.

I think I'm somewhat more inclined to say that what this should remind us all of is just how extraordinarily complex and uncertain these issues are.

And if nothing else, seems to me it ought to give us a lot of humility about whatever opinions we have and cause us to continue to try to understand better what we're facing and hopefully, and hope that our political system is equally thoughtful in trying to work its way through these deeply, deeply complex, deeply uncertain and consequential issues. Thank you all for being with us.

(End of presentation)